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Spinning and Underpricing: A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings

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ARTICLE

Spinning and Underpricing

A LEGAL AND ECONOMIC ANALYSIS OF THE PREFERENTIAL ALLOCATION OF SHARES IN INITIAL PUBLIC OFFERINGS*

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Abstract

This Article investigates the preferential allocation, or "spinning," of shares in initial public offerings. It begins by examining the offering process and the incentives of underwriters, issuers, and investors. Through this examination of the participants and the process, it locates the harm of spinning in the underpricing of initial public offerings. The Article then seeks to identify precisely which participants in the offering process are harmed by the practice and finally evaluates the most appropriate means of addressing this harm.

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I. INTRODUCTION

The millennium boom is over.[1] With the decline of the stock market in recent years, the triumphal tales of newly minted millionaires, early retirements, and government surpluses have given way to the schadenfreude of seeing the mighty laid low. The accusations and indictments surrounding the likes of Dennis Kozlowski,[2] Martha Stewart,[3] and Frank Quattrone[4] now seem to suggest that the game was fixed, that making money in the market depended not on how smart you were but on who you were, not on what you knew but on whom you knew. One of the stories emerging from the market during this period and sounding similar themes involved the preferential allocation, or "spinning," of shares in initial public offerings.

An initial public offering of equity, or "IPO," is a company's first sale of shares into the public market. Although the company may already have a number of shareholders, who purchased their stakes in relatively small, *private* financings, the IPO is the company's first distribution of shares to the investing public, after which the shares will trade on a secondary market, such as the New York Stock Exchange. By the end of the 1990s, IPO shares had become an extremely popular investment option.[5] New issues became so popular, in fact, that investors were often unable to purchase shares in the

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[1] *See, e.g.*, ROBERT J. SHILLER, IRRATIONAL EXUBERANCE 4, 6 (2000) (coining the phrase "millennium boom" to refer to the increase in the Dow Jones industrial average, which "stood at around 3,600 in early 1994[, but] had passed 11,000 [by 1999], more than tripling in five years, a total increase in stock market prices of over 200%").

[2] *See* Mark Maremont & Jerry Markon, *Ex-Tyco Chief Evaded $1 Million in Taxes on Art, Indictment Says*, WALL ST. J., June 5, 2002, at A1 (describing indictment).

[3] Kara Scannell & Laurie P. Cohen, *Martha Stewart, Broker Indicted: Homemaking Maven Pleads Not Guilty to Criminal Counts; SEC Files Civil Insider Charges*, WALL ST. J., June 5, 2003, at C1 (describing indictment of Martha Stewart on criminal charges of securities fraud, conspiracy, and making false statements to federal agents).

[4] Randall Smith & Kara Scannell, *Quattrone Is Indicted and Fresh Details Emerge*, WALL ST. J., May 13, 2003, at C3 (describing indictment for obstruction of justice and witness tampering). *See also infra* notes 51-52 and accompanying text.

[5] *See* Susanne Craig, *Allocations of IPOs: A Guide to the Game*, WALL ST. J., Aug. 29, 2002, at C1 ("Shares of most initial public offerings jump in value immediately after they begin trading. In the heydey of the Internet boom, first-day pops of more than 100% were frequent, though typically increases have been in the range of 10% to 20%.").

offering itself and were forced, instead, to buy in the secondary trading market, often at vastly inflated prices.[6] This demand for IPO shares empowered the underwriter – that is, the investment bank managing the distribution of shares in the offering – to allocate shares to investors on a preferential basis.[7] Or, more colloquially, to *spin* shares in the IPO.

Used in this context, "spinning" refers to the preferential allocation of the right to buy in an IPO. An investment bank engages in spinning when it allocates IPO shares to specific individuals, such as company managers or prominent venture capitalists, so that those individuals may quickly resell, or "flip," the shares for a profit.[8] Spinning differs from ordinary allocation practices in a number of ways. First, these allocations are directed to *individuals* rather than the institutional investors that ordinarily receive the lion's share of attention in IPOs.[9] Second, the underwriters direct spinning

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[6] *See* Terzah Ewing & Joshua Harris Prager, *Many Are Finding IPOs Still Out of Reach*, WALL ST. J., Feb. 28, 2000, at C21 ("Small investors receive less than a quarter of the shares in the average IPO, and the hotter the deal, the more scarce the shares available to [the] small fry.").

[7] This Article focuses on allocation decisions made by the managing underwriters and other members of the underwriting syndicate, referring to these collectively as the "underwriter." It does not address allocation decisions by the issuer itself. Although an issuer's allocation decisions may also involve favoritism and wealth-transfers, when compared to the underwriter, the issuer's allocation decisions influence a miniscule proportion of the total offering and are often confined to a small directed share plan or "friends and family" program. *See generally* Alan K. Austin, Allison Bennington & Dorrian Porter, *The SEC Cracks Down on Directed Share Programs*, INSIGHTS, Oct. 1999, at 2 (describing problems raised by directed share programs); Michael E. Lubowitz & Erika L. Weinberg, *IPO Participation Rights*, INSIGHTS, July 2000, at 7 (discussing other participation rights given by issuers in their public offerings).

[8] *See* Meredith B. Cross & Christine Sarudy Roberts, *Recent Developments in Underwriting of IPO's: "Spinning" and Syndicate Penalty Bids, in* 30TH ANNUAL INSTITUTE ON SECURITIES REGULATION 595, 597 (PLI Corp., No. 1084, Nov. 1998) ("Spinning occurs when an underwriter allocates shares of a new issue to the personal brokerage account of an executive who then may flip the shares into the market for a quick profit."). IPO allocations to individuals outside of the spinning context are often encumbered by anti-flipping restrictions. *See, e.g.*, Civilian Capital, Inc., *Civilian Captial's IPO Flipping Policy* (describing one firm's policies and procedures in connection with the flipping of IPO shares), *at* (last visited Feb. 1, 2004).

[9] As described in Part III.A.4, *infra*, institutional investors are favored buyers due to their buying power and consistent participation in the market for new issues. *See* Gregg Wirth, *Syndicates Want IPO Tracking System Expanded*, INVESTMENT DEALERS' DIGEST, Dec. 1, 1997, at 6 (describing the role of institutional investors as a function of their buying power and repeat play). *See also* Kathleen Weiss Hanley & William J. Wilhelm, Jr., *Evidence on the Strategic Allocation of Initial Public Offerings*, 37 J. FIN. ECON. 239, 240 (1995) (finding over a sample of 38 IPOs during the period 1983-88 that "approximately 70% of the shares in underpriced offerings are allocated to institutional investors"); Letter from Jane C. Sherburne, Deputy General Counsel of Citigroup, Inc., to Michael G. Oxley, Chairman of the House Committee on

allocations to *particular* individuals, usually those in positions of power and influence, rather than leaving the syndicate's brokers with the discretion to dole out individual allocations to just anyone.[10] Third, a spinning allocation, unlike an ordinary allocation from the retail pot, is generally free from aftermarket trading restrictions.[11] Finally, spinning allocations rarely, if ever, result in trading losses.[12]

In addition to attracting a wealth of bad press,[13] the practice of spinning has spurred a variety of regulatory efforts.[14] To date, most of the media and regulatory attention has focused on the role of the investment banks, and this is perhaps unsurprising. Just as issuers raise capital on Wall Street, elected officials may seek to raise *political* capital by

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Financial Services & John J. LaFalce, Ranking Member of the House Committee on Financial Services (Aug. 26, 2002) (responding to Aug. 23, 2002 subpoena and stating, "In the typical IPO, the percentage of offered shares allocated to institutional investors generally ranges from 70% to 85% of the total shares."), *available at* http://financialservices.house.gov/media/pdf/citidocs_001.pdf.

[10] *See* Michael Siconolfi, *The Spin Desk: Underwriters Set Aside IPO Stock for Officials of Potential Customers,* WALL ST. J., Nov. 12, 1997, at A1 ("A small number [of shares], known as the 'retail pot,' are set aside for individuals, and spin shares typically come from this pot."). *See also* RICHARD W. JENNINGS ET AL., SECURITIES REGULATION: CASES AND MATERIALS 89-95 (8th ed. 1998) (describing allocation authority over the "retail pot").

[11] Because underwriters are concerned that aftermarket "flipping" may drag down the offering price, they typically force broker-dealers to agree, in the Agreement Among Underwriters, to forfeit selling commissions if their clients flip the shares. In order to protect its selling commission, a broker-dealer will ordinarily allocate only to clients who agree not to flip securities and seek to punish those who do flip their shares. *See generally* Civilian Capital, *supra* note 8 (describing one firm's policy regarding flipping); Ewing & Prager, *supra* note 6 ("Individual investors are punished more severely than institutional ones for 'flipping' stock, or selling it on IPO day for a quick profit. The punishments typically take the form of shutting offenders out of future deals for a set period of time."). Spinning allocations are unencumbered by anti-flipping restrictions.

[12] Because it is not much of a privilege to buy into a losing investment, underwriters only spin shares of hot offerings – that is, those for which there is significant aftermarket demand. *See generally* Siconolfi, *supra* note 10 (describing the practice).

[13] *See id.* (breaking the story of underwriter favoritism in IPO allocations). *See also* Don Bauder, *Initial Public Offering Craze Created New Breed of Pirates,* COPLEY NEWS SERVICE, Oct. 18, 2002 ("The initial public offering, or IPO, craze of the late 1990s was not lunacy. It was piracy - criminal piracy, in my judgment."); Lee Drutman & Charlie Cray, *The Top 10 Financial Scams of the 2002 Corporate Crime Wave (The 10 Worst Corporations of 2002),* MULTINATIONAL MONITOR, Dec. 1, 2002, at 20 (complaining that through spinning allocations "already rich executives got even richer on IPOs while ordinary investors were shut out of the profitable IPO offerings"); Michael Siconolfi, *SEC, NASD Begin Probes of IPO 'Spin' Accounts,* WALL ST. J., Nov. 13, 1997, at A3 (announcing commencement of regulatory investigation); James Surowiecki, *The Stock Spinners,* SLATE MAGAZINE, Jan. 16, 1998 (comparing spinning to bribery).

[14] *See infra* Part V.B.

exploiting Main Street's distrust of Wall Street.[15] Similarly, the many securities lawsuits filed against investment banks in connection with IPO practices can be understood as another kind of capital raising, recalling the answer attributed to Willie Sutton when asked why he robbed banks: "Because that's where the money is."[16]

Yet for all of the attention devoted to investment banks in connection with IPO practices, the perspective of the banks' clients – the issuers of securities – has been largely overlooked. But it is the issuer's role in these transactions that matters most. It is the issuer that is selling its shares in the offering. It is the issuer the public is buying into, either in the primary distribution or in the aftermarket. It is the issuer's managers who receive spinning allocations, and it is the issuer's shares that are subsequently spun to other managers of other issuers. The failure to focus on the issuer's role in spinning allocations has left a number of foundational questions unanswered: What

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[15] *See generally* STUART BANNER, ANGLO-AMERICAN SECURITIES REGULATION: CULTURAL AND POLITICAL ROOTS, 1690-1860 (1998).

> The familiar modern rift between Wall Street and Main Street – between a community of securities professionals pursuing its private interest while certain that it is meanwhile essential to the public welfare, and a wider political community suspicious of both the practices and the power of the securities industry – is as old as securities trading.

Id. at 4. Senator Oxley and New York State Attorney General Spitzer have made names for themselves as crusaders against Wall Street corruption, although they have occasionally disagreed about the proper source and direction of reform. *See, e.g.*, Corporate Governance: Hearings Before the Subcomm. on Consumer Affairs, Foreign Commerce and Tourism of the Senate Comm. on Commerce, Science and Technology, 107th Cong. 6-7 (June 2002) (testimony of Eliot Spitzer, New York State Attorney General charging that it was "difficult to conceive of a more passive, or inadequate, response" to the problems facing securities regulators than that proposed by Senator Oxley through the House Financial Services Committee), *available at* http://www.senate.gov/~commerce/hearings/062602spitzer.pdf (last visited Feb. 1, 2004); Michael Oxley, *Letter to the Editor*, N.Y. TIMES, June 9, 2002, § 3 (accusing Spitzer of leading a "regulatory coup" that would result in the "balkanization" of securities regulation).

[16] *See* Steve Cocheo, *The Bank Robber, The Quote, and the Final Irony* (noting the doubtful origins of the famous quotation), *at* http://www.banking.com/aba/profile_0397.htm (last visited Feb. 1, 2004); *see also* WILLIAM FRANCIS SUTTON, WHERE THE MONEY WAS (1976) (describing a life of bank robbery). Some of the private claims filed against investment banks in connection with practices during the bubble market have reached a conclusion. *See, e.g., In re* Merrill Lynch & Co., Inc. Research Reports Sec. Litig., 273 F. Supp. 2d 351, 358 (S.D.N.Y. 2003) (dismissing suits against Merrill Lynch for analyst conflict of interest because "plaintiffs were among the high-risk speculators who, knowing full well . . . the unjustifiable risks they were undertaking in the extremely volatile and highly untested stocks at issue, now hope to twist the federal securities laws into a scheme of cost-free speculators' insurance").

is the perspective of the issuer on spinning? How does spinning affect the issuer and its shareholders?

This Article examines spinning from the perspective of the issuer, focusing specifically on spinning allocations awarded by underwriters to the mangers of issuers that they have taken or will take public. It seeks to account for why and how spinning occurs, what purpose spinning serves, which mechanisms make it possible, and what effect the practice has on issuers and their shareholders. Each of these lines of inquiry reveals a connection between spinning and the well-documented phenomenon of underpricing in IPOs – that is, the failure of new issues to be priced at, or even near, their aftermarket value[17] – a phenomenon which grew to unprecedented proportions in the bull market of the late 1990s.[18] As this Article will show, underpricing is both a means and an end of spinning. Underpricing enables spinning by providing underwriters with a ready supply of hot IPO shares. But underpricing is also an end of spinning when hot

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[17] Underpricing may be measured in terms of percentage deviations from aftermarket price or in dollar terms as forgone offering proceeds or "money left on the table." Regardless of the metric, the offering price of IPO shares tends to be systematically lower than the price at which the shares trade in the immediate aftermarket. *See* Tim Loughran & Jay R. Ritter, *Why Don't Issuers Get Upset About Leaving Money on the Table in IPOs?*, 15 REV. FIN. STUD. 413 (2002) [hereinafter Loughran & Ritter, *Money on the Table*] (defining "money on the table" as the aggregate proceeds foregone in underpricing). Persistent underpricing in the IPO market may be taken as evidence that the market is not efficient. *See, e.g.*, Jonathan A. Shayne & Larry D. Soderquist, *Inefficiency in the Market for Initial Public Offerings*, 48 VAND. L. REV. 965 (1995) (arguing that the IPO market is inefficient and that securities law should be reformed to improve it).

[18] *See* Tim Loughran & Jay R. Ritter, *Why Has IPO Underpricing Changed Over Time?*, at 12 (AFA 2003 Washington, DC Meetings, Dec. 3, 2002) [hereinafter Loughran & Ritter, *Underpricing Over Time*] ("In the 1980s, the average first-day return was slightly over 7%. In the 1990s, the average first-day return increased to almost 15%, and then jumped to 65% in the internet bubble period."), *available at* http://ssrn.com/abstract=331780. In 1999, at the height of the technology bubble, there was a difference of more than $27 billion between the aggregate offering price of IPOs and the trading price of those issues on their first day in the aftermarket. Loughran & Ritter, *Money on the Table*, *supra* note 17, at 413 ("During 1990-1998, companies going public in the United States left more than $27 billion on the table, where the money left on the table is defined as the first-day price gain multiplied by the number of shares sold."). *See also* John C. Coffee, *IPO Underpricing and Dutch Auctions*, N.Y.L.J., Sept. 16, 1999, at 5 ("IPO underpricing . . . has increased at a hyperbolic rate."); Alexander P. Ljungqvist & William J. Wilhelm, Jr., *IPO Pricing in the Dot-com Bubble*, at 1 ("In 1996, first-day returns on IPOs averaged about 17 percent (median: 10 percent). In 1999, first-day returns averaged 73 percent (median: 40 percent) before tapering off to 58 percent (median: 30 percent) in 2000."), *available at* http://www.afajof.org/pdf/forthcoming/ljungqvist.pdf (last visited Feb. 1, 2004); Robert McGough & Randall Smith, *Heard on the Street: IPO Issuers Don't Mind Money Left on the Table*, WALL ST. J., Nov. 3, 1999, at C1.

allocations are used to induce issuer-managers to underprice their own offerings.[19] It is this double aspect of the relationship between spinning and underpricing that animates the legal and economic discussion in this Article.

From this Introduction, the analysis proceeds as follows: Part II situates spinning in the context of the offering process and reviews the underwriter's incentives in marketing IPO shares. Part III considers spinning and underpricing from the perspective of the issuer. Part IV addresses spinning from the perspective of investors in the market for new issues and investigates possible investor complaints regarding the allocation of IPOs. Part V turns to the question of remedies for those harmed, evaluating the solutions currently available under both private litigation and public regulation before proposing its own solution to the excesses associated with the allocation of hot offerings. The Article then closes, in Part VI, with a brief summary and conclusion.

II. UNDERWRITERS AND UNDERPRICING

Underwriters take on risk. In a firm commitment underwriting, the underwriting arrangement preferred by issuers,[20] the underwriter first purchases all of the shares to be

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[19] This Article uses the concededly inelegant phrase "issuer-manager" to refer to the managers of companies issuing shares in public offerings. It also uses the term "manager" throughout to refer to both officers and directors. Although this term threatens to muddle various distinctions between the two corporate roles, officers and directors have a common fiduciary obligation that is, for purposes of this Article, more significant than any of their differences – that is, the duty of loyalty. The substance of this duty, whether owed by directors as shareholder fiduciaries or by officers as corporate agents, does not differ significantly. *See infra* Part IV.C (discussing spinning as a breach of the duty of loyalty) and note 185 (describing the duty of loyalty of agents owed to their principals). Moreover, the breadth of the term "manager" more aptly captures the reality of the practice where spinning recipients often functioned as both officers, frequently the CEO, and directors. *See infra* notes 44-47 and accompanying text (noting centrality of CEOs in allocation decisions).

[20] Public offerings are distinguishable, broadly, by whether they are underwritten on either a "firm commitment" or "best efforts" basis.

> In a firm commitment underwriting, one or more investment banking firms agree to purchase the securities from the issuer for resale to the public at a specified offering price. In a best efforts underwriting, broker-dealers do not purchase the securities from the issuer but instead agree for a fee to use their best efforts to sell the securities on behalf of the issuer at the offering price.

In re National Association of Securities Dealers, Inc., Exchange Act Release No. 17,371 (Dec. 12, 1980).

sold in the offering, then resells them to the public. This arrangement exposes the underwriter to the risk that the issuer's shares will not sell quickly, or worse, that they will not sell at all. An issue that does not sell will increase the underwriter's cost of capital,[21] exacerbate opportunity costs,[22] and harm the underwriter's reputation.[23] These are sometimes referred to as the risks of a "sticky issue."[24]

Underwriters are, of course, rewarded for bearing these risks. They are compensated for their efforts by the right to

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Because firm commitment offerings are preferred to best efforts offerings by both investors and issuers, this article focuses exclusively on IPOs underwritten on a firm commitment basis. *See generally* James M. Johnson & Robert E. Miller, *Going Public: Information for Small Businesses,* J. SMALL BUS. MGMT., Oct. 1985, at 38 (showing favorable comparison of firm commitment offerings to best efforts offerings).

[21] If the shares do not sell quickly, the underwriter suffers this cost in the form of ongoing interest payments and opportunity loss. If some shares do not sell at all, the cost of unsold shares represents a total loss to the underwriter.

[22] *See generally* PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, ECONOMICS, 128 (16th ed. 1998) (defining opportunity cost as "the value of the good or service forgone").

[23] Underwriters stake their reputations on the issues they bring to the market, implicitly certifying to buyers that shares of the issuer are worth the offering price. This is the "certification function" of underwriting, which serves to break down the information asymmetry between issuers, who have incentives to misrepresent themselves in order to raise capital, and potential investors, who are unable to ascertain the fundamental value of the issuer. *See* James R. Booth & Richard L. Smith, II, *Capital Raising, Underwriting, and the Certification Hypothesis,* 15 J. FIN. ECON. 261 (1986) [hereinafter Booth & Smith, *Capital Raising*]; Clifford W. Smith, *Investment Banking and the Capital Acquisition Hypothesis,* 15 J. FIN. ECON. 3, 16 (1986) ("[I]n addition to a marketing function, the investment banker performs a monitoring function analogous to that of bond rating agencies, of independent auditing firms, of outside members of a firm's board of directors, and of insurance companies.") (internal citations omitted).

If an underwriter fails to sell an offering, it will discredit itself in the marketplace. Future issuers may be reluctant to use an underwriter that has demonstrated an inability to place its clients' shares. Similarly, future buyers will be reluctant to accept IPO allocations from underwriters who have shown poor judgment in their selection of issuers. Any decline in an underwriter's prestige can thus signal the beginning of a vicious cycle. The best issuers place their offerings only with the most prestigious underwriters. If an underwriter's reputation declines, it may be forced to underwrite less desirable offerings, which increases the risk of a sticky issue, which may lead to a further decline in the underwriter's prestige and even less desirable offerings at greater risk, and so on. *See generally* Seha M. Tiniç, *Anatomy of Initial Public Offerings of Common Stock,* 43 J. FIN. 789 (1988) (finding support for the certification function); Glenn A. Wolfe et al., *An Analysis of the Underwriter Selection Process for Initial Public Offerings,* 17 J. FIN. RSCH. 77, 89 (1994) (sampling period 1977-88 and concluding that "[b]y emphasizing larger, less risky issues and demonstrating sensitivity to market conditions, prestigious investment bankers attempt to manage the risk associated with underwriting unseasoned new issues").

[24] *See* JAMES D. COX, ROBERT W. HILLMAN, & DONALD C. LANGEVOORT, SECURITIES REGULATION: CASES AND MATERIALS 209 (3d ed. 2001) (defining a sticky issue as "an offering for which investor interest is so weak that the underwriters require a much longer time to sell the issue than expected or, worse, they cannot sell the entire amount").

purchase the issuer's shares at an agreed-upon discount, often seven percent, from the price at which the shares will be offered to the public.[25] Underwriters may also contract with the issuer for the right to sell additional shares if the offering turns out to be popular,[26] thus increasing their upside risk, or for the right to abandon the offering under certain circumstances,[27] thereby limiting their downside risk.

In addition to these means of managing risk, underwriters may also manipulate the price of the offering. Two motivations for doing so – minimizing the risk of the offering and maximizing returns through side deals involving IPO allocations – are the focus of the following sections.

A. *Underpricing as Insurance*

Risky issues only harm underwriters if demand for the offering settles on a price below the offering price, saddling the

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[25] The seven percent commission figure recently demonstrated such consistency – uniformly charged by 25 different firms for IPO offerings between $20 million and $80 million – that it became the subject of a federal antitrust probe. *See* Randall Smith, *U.S. Ends Probe Into Underwriting Fees Charged by Securities Firms for IPOs,* WALL ST. J., Apr. 9, 2001, at C11 (announcing the end of the Department of Justice's probe into possible price fixing by underwriters). *See also* Hsuan Chi Chen & Jay R. Ritter, *The Seven-Percent Solution,* 55 J. FIN. 1105 (2000) (arguing that the seven percent commission rate is the result of implicit collusion among investment banks). *But see* Robert S. Hansen, *Do Investment Banks Compete in IPOs?: The Advent of the "7% Plus Contract,"* 59 J. FIN. ECON. 313 (2001) (arguing that empirical evidence supports efficient contract theory rather than collusion in setting commission rates at seven percent).

[26] This is the underwriter's "overallotment option" or "shoe." *See generally* Raymond Hennessey, *Deals & Deal Makers: IPO Outlook: Shift in IPO Issuers Spreads Proceeds From Overallotments,* WALL ST. J., July 8, 2002, at C5.

> Overallotments are an amount of shares set aside by a company that allow for underwriters to purchase extra shares in the offering at the offering price. For example, if a company offers five million shares in an IPO, it may set aside 750,000 shares over that amount to cover overallotments.

Id.

[27] Such clauses typically include exit rights for the suspension of market trading, war or national emergency, as well as a material adverse change in either markets generally or the issuer's business in particular. The underwriter's exit rights in a firm commitment underwriting are limited, due in part to a pronouncement of the SEC that extensive walk away rights are inconsistent with a firm commitment offering. *See* First Boston Corp., SEC No-Action Letter, Fed. Sec. L. Rep. (CCH) ¶ 78,152 (Sept. 2, 1985):

> [M]arket out clauses . . . [that] permit an underwriter to terminate its obligations to purchase the offered securities from the issuer based upon . . . an inability to market the securities . . . are inappropriate in the context of a firm commitment underwriting. Such clauses place the risk of the success of the offering upon the issuer and result in the underwriter participating upon a "best efforts" basis.

Id.

underwriter with a sticky issue, an offering it cannot sell. A large spread between the offering price and the anticipated aftermarket price insures the underwriter against the risk of a sticky issue. Underwriters may underprice offerings to create this spread and thereby reduce their risk.

This form of insurance is expensive. Underwriters receive it only by foregoing additional sales commissions. At its limits, reducing risk through underpricing would erase the underwriter's compensation. However, underwriters probably only consider underpricing as insurance at higher price levels, where the increased risk of a sticky issue marginally outweighs the expected return from an incremental increase in offering price.[28]

Focusing on underpricing as insurance against a sticky issue may give rise to the objection that insurance does not seem necessary where an offering is oversubscribed.[29] If abundant investor interest is revealed during the marketing of an issue,[30] there would seem to be little chance that the offering will not sell, and the underwriter would seem to risk very little by increasing the offering price. And indeed, in such situations, the offering price is often adjusted upwards, above the initial price estimate, or "file range."[31] Yet even after this upward adjustment, underpricing persists.[32]

B. Underpricing as Underwriter Welfare Maximization

In addition to providing additional insurance against the risk of a sticky issue, underwriters may be able to increase profits above their base compensation by engaging in

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[28] In other words, underpricing as insurance may not be a factor in deciding to set the offering price at $10 rather than $1, but may become a critical consideration in the determination of whether to move the price up to $17 from $15. In the later case, the underwriter's additional gains of $0.14 per share sold may be outweighed by the additional risk that, at the higher price, the shares will sell slowly or not at all.

[29] An issue is oversubscribed when orders exceed shares issued. *See* Note, *Auctioning New Issues of Corporate Securities*, 71 VA. L. REV. 1381, 1383 n.13 (1985). When an issue of stock is oversubscribed there is every reason to believe the price of the stock will rise when it is released for trading. *See also infra* note 210.

[30] For more detail on the book-building process, see *infra* Part III.A.4.

[31] The "file range" is the initial estimate filed with the SEC after the filing of the registration statement, when the underwriter begins its book-building efforts.

[32] *See, e.g.*, Kathleen Weiss Hanley, *The Underpricing of Initial Public Offerings and the Partial Adjustment Phenomenon*, 34 J. FIN. ECON. 231, 232 (1993) (reporting that issues setting a final offering price below the file price range have average first day gains of 0.6% while those setting a final offering price above the file price range enjoy an average 20.7% first day premium).

underpricing. This may seem contradictory since, as noted above, underwriter compensation is a percentage of aggregate offering proceeds, which are maximized by raising, not lowering, the offering price. However, underpricing creates an additional profit opportunity for underwriters by enabling the practice of spinning.

Spinning improves the underwriter's welfare by generating goodwill on the part of the recipient of the spun shares. By granting highly profitable IPO allocations to savvy business-people who well understand that nothing in this world is free,[33] underwriters can expect real returns on their investment in goodwill. Of course, because one is not normally grateful for the opportunity to participate in losing investments, the creation of goodwill will only succeed if the underwriter is able to churn out *profitable* IPO allocations – that is, shares that can be sold into the aftermarket at a higher price than the recipient paid for the allocation. Underwriters assure themselves of a supply of shares for spinning by underpricing IPOs.[34]

Underwriters may spin underpriced IPO shares to create goodwill in a number of ways, some of which are plainly illegal while others take place in the dim interstices of law and regulation. First, an investment bank may seek to use spinning allocations to create goodwill among its brokerage clients. Individuals who trade actively with the bank and generate large trading commissions for the bank's retail brokerage department may be allocated IPO shares as a reward for their account activity and as an inducement to keep it up.[35] When the

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[33] The primary example is lunches. *See generally* MILTON FRIEDMAN, THERE'S NO SUCH THING AS A FREE LUNCH (1975). However, the famous phrase apparently did not originate with Friedman. *See* E.M. Hugh-Jones, *Inquest on Nationalization,* 62 ETHICS 169, 183 (1952) ("It was summed up, I think, by Professor Alvin Hansen in his famous TINSTAAFL formula – 'There is no such thing as a free lunch.'").

[34] Apart from foregone commissions, spinning costs the underwriter very little since there are a number of regulatory barriers to price discrimination in public offerings of stock. *See* Securities Exchange Act of 1934, Regulation S-K, 17 C.F.R. § 229.501(b)(3) (2002) (requiring disclosure of any deviation from fixed-price offering practices); Harry S. Gerla, *Swimming Against the Deregulatory Tide: Maintaining Fixed Prices in Public Offerings of Securities Through the NASD Antidiscounting Rules,* 36 VAND. L. REV. 9 (1983) (reviewing NASD rules on the subject). Selling a few more shares to individuals rather than institutions should make no difference to the underwriter since both buyers will pay the same price.

[35] This seems to have been a common practice at Credit Suisse First Boston. *See, e.g.,* Complaint of the Securities and Exchange Commission, SEC v. Credit Suisse First Boston Corp., 2002 U.S. Dist. LEXIS 2416 (D.C. Cir. Jan. 22, 2002) (No. 02 CV 0090) (alleging that CSFB engaged in allocation practices designed to increase its brokerage commissions), *available at* http://www.sec.gov/litigation/complaints/

individual recipients of these allocations are also fund managers at institutions, such allocations may run afoul of the NASD's Free-Riding and Withholding Rules,[36] which were violated often enough in the late 1990s for the NASD to issue a notice reminding its members that IPO shares could not be allocated to fund managers.[37] Even when they are followed, however, the Free-Riding and Withholding Rules do not prevent shares from being allocated to the institutional *fund*, rather than the fund's *managers*, to reward or induce regular investment in the bank's underwriting activities or active trading in the bank's brokerage department.[38] Moreover,

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complr17327.htm. *See also* Susan Pulliam & Randall Smith, *Deals & Deal Makers: CSFB Officials Set Quota for Repayment of IPO Profits in Form of Commissions,* WALL ST. J., Aug. 10, 2001 (discussing highly formalized methods used by CSFB to generate a return on its IPO allocations through brokerage commissions, and discussing a meeting in which "[a CSFB trader] told a hedge fund manager: 'You get $3 – we get $1.' . . . In other words, the firm expected the manager to pay commissions to CSFB equal to 33% of his profits on the CSFB-led new stock issues that he received."). Another CSFB salesperson is quoted as saying:

> They all had the same sheets . . . . [They] would say the account got X number of shares, made X million in profits after 10 days, 30 days and 90 days. They would say this was your profit, and we want to maintain a ratio [of brokerage commissions to IPO profits].

Id. See also infra note 40.

[36] *See* National Association of Securities Dealers, Inc., NASD Manual Conduct Rules, Rule IM-2110-1(b)(4) (2003) (Standards Of Commercial Honor And Principles Of Trade) (barring allocations of hot issues to officers who may influence the investment decisions of any "institutional type account," including "a bank, savings and loan institution, insurance company, investment company, [and] investment advisory firm"). The current Free-Riding and Withholding Rule will be replaced by early 2004 with a new version, Rule 2790, which like the current rule, will bar allocations to persons with investment authority for banks and other kinds of institutional funds, but also like the current rule, will not prohibit allocations to the funds themselves or to managers of business corporations, as opposed to investment funds. *See* Self-Regulatory Organizations, Exchange Act Release No. 34-48701 (Oct. 24, 2003) (approving the new rule), *available at* http://www.sec.gov/rules/sro/34-48701.htm.

[37] *See* NASD Regulation, Inc., NASD Notice to Members (97-91), *NASD Reminds Members of Obligations Under the Free-Riding and Withholding Interpretation* (Nov. 1997). Lehman Brothers was one of the violators. *See* Diana B. Henriques, *Lehman Fined $100,000 in Sale of Hot Initial Stock Offerings*, N.Y. TIMES, June 24, 1999, at C3. ("Lehman was accused of selling shares to investors who should not have been allowed to buy, failing to adequately determine whether other purchasers could legally buy shares, and inaccurately reporting to regulators the percentage of each of the disputed offerings that had been sold to public investors.").

[38] Inflated commission rates or needless portfolio activity may be a price that brokerage clients are willing to pay for access to IPO allocations. *See* Andrew J. Chalk & John W. Peavy III, *Understanding the Pricing of Initial Public Offerings,* 8 RES. IN FIN. 203, 206 (1990) (explaining underpricing as a natural outcome of the pricing process and arguing that "the investor who receives an allotment in an IPO must pay for the abnormal return . . . . [Because] the institutional framework precludes the explicit use of a discriminatory auction, . . . the fee for IPO allocations is bundled into other services provided by the investment bank."); Andrew J. Chalk & John W. Peavy, III, *IPOs: Why Individuals Don't Get the "Hot" Issues,* 9 AAII J. 16 (March 1987)

regulators have been generally slow to apply the Free-Riding and Withholding Rules more broadly – to individuals not associated with institutional investment accounts.[39] Nevertheless, the common institutional giveback of inflated commissions to banks through brokerage transactions has attracted regulatory scrutiny.[40]

(arguing that the favoritism shown to brokerage customers is evidence of an implicit discriminatory pricing scheme, according to which investors who are willing to pay inflated commissions or churn their portfolios are allocated underpriced offerings as a kind of *quid pro quo*); Aaron Lucchetti, *SEC Probes Funds' Commissions,* WALL ST. J., September 16, 1999, at C1 (noting that "fund executives point out that higher commissions can be justified by . . . the access they can provide to initial public offerings"). The wealth transfer taking place here thus involves the following steps: (1) the investment bank gets the issuer to accede to underpricing; (2) the investment bank transfers the value of underpricing to the brokerage customer, and (3) the brokerage customer transfers some of the value back to the investment bank in the form of excess or inflated commissions.

[39] In 1998, the NASD amended the rules but did not take the opportunity specifically to address spinning. *See* NASD Regulations, Inc., NASD Notice to Members (98-48), *SEC Approves Amendments to Free-Riding and Withholding Interpretation* (Aug. 17, 1998). Similarly, the SEC has not used its power over mandatory disclosure to regulate spinning, asserting narrowly that the undisclosed receipt of a spinning allocation by a *fund manager* may trigger disclosure obligations for the recipient, but failing to assert that the *issuer's* disclosure obligations are affected by spinning. *See, e.g., In re* Monetta Financial Services, Inc., Securities Act Release No. 33-7510 (Feb. 26, 1998) (stating that Rule 10b-5 and § 17 of the Securities Act require fund managers to disclose their acceptance of spinning allocations to their investors). General disclosure obligations relating to the issuer's plan of distribution are set forth in Regulation S-K Item 508. *See* Securities Exchange Act of 1934, Regulation S-K, 17 C.F.R. § 229.508 (Plan of Distribution) (2002). However, these have not been interpreted to require an issuer to disclose a manager's receipt of a spinning allocation on the basis that, without an explicit agreement, there is not a sufficiently material relationship between the issuer and the underwriter to require special disclosure. *See* Cross & Roberts, *supra* note 8, at 599 ("The receipt of IPO shares from an underwriter by an executive of the company, absent other factors suggesting a *quid pro quo* relationship, would not seem to be a material relationship for purposes of Item 508(a)."). *See generally* HAROLD S. BLOOMENTHAL ET AL., HANDBOOK: GOING PUBLIC, THE INTEGRATED DISCLOSURE SYSTEM AND EXEMPT FINANCING § 3.13-3.14 (2001) (noting broad discretion of underwriting syndicate, free from SEC intervention, to allocate an offering).

[40] Suits filed by the SEC and the NASD have led to settlements with CSFB, Robertson Stephens, and J.P. Morgan Chase in connection with discriminatory brokerage pricing and IPO allocations. *See* News Release, National Association of Securities Dealers, Inc., NASD Charges Robertson Stephens with Sharing in Millions of Dollars of Customers' Profits in Exchange for "Hot" IPO Shares (Jan. 9, 2003) (announcing settlement by Robertson Stephens to pay each of the NASD and the SEC $14 million in connection with allegations that it wrongfully profited by charging excess commissions in connection with the allocation of hot IPO shares), *available at* http://www.nasdr.com/news/pr2003/release_03_001.html; SEC Litigation Release No. 17327 (Jan. 22, 2002) (announcing settlement between SEC and CSFB for $100 million), *available at* http://www.sec.gov/litigation/litreleases/lr17327.htm; Randall Smith, *J.P. Morgan Chase to Pay $6 Million in the IPO Case,* WALL ST. J., Feb. 21, 2003, at C5 (describing settlement relating to IPO allocations and brokerage practices of J.P. Morgan's Hambrecht & Quist unit).

Underwriters may also seek to use spinning allocations to win the favor of politicians and government officials. A recent illustration took place in Japan during the late 1980s, when numerous Japanese political figures, including Prime Minister Noboru Takeshita, received shares of Recruit Cosmos shortly before the company went public and the aftermarket price soared.[41] The apparent quid pro quo involved in these allocations created a scandal that forced the Prime Minister and his entire cabinet to resign.[42]

In the United States, spinning allocations to corporate managers have similarly raised the specter of bribery and corruption.[43] Allocations to corporate managers may be divided into two types: allocations to managers of *public* companies and allocations to managers of *private* firms planning a public offering. Each of these practices raises distinct concerns.

Because managers of public corporations, especially CEOs and CFOs, exercise broad authority over the choice of investment bank when their companies engage in acquisitions or capital-raising transactions, there may be considerable value in establishing a relationship of goodwill with them. And indeed, recent media accounts have documented numerous such relationships, including those between Goldman Sachs and Kenneth Lay, formerly of Enron, and Dennis Kozlowski, formerly of Tyco,[44] as well as those between Salomon Smith Barney and the now-former CEOs of WorldCom (Bernard Ebbers) and Qwest (Joseph Nacchio), among others.[45] The practice may have become so common that top managers felt

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[41] *See* Amy Borrus, *The Recruit Scandal Bubbles to the Top,* BUS. WK., Mar. 20, 1989, at 55 ("Recruit, a young company, sought influence in high places by selling cheap shares in a real-estate subsidiary, Recruit Cosmos, to 160 top politicians, bureaucrats, and business leaders."); Stefan Wagstyl, *Takeshita Resists Party Pressure to Quit Over Recruit,* FIN. TIMES, Apr. 8, 1989, at I-2 (reporting that Prime Minister Takeshita received Recruit shares).

[42] *The Monsters Stalking Politicians' Dreams,* ECONOMIST, Apr. 29, 1989, at 31 (describing the decision of Takeshita and his cabinet to resign following the scandal). The Recruit Cosmos case resulted in several prosecutions in Japan, including bribery and corruption charges against the chairman of Recruit. *See Recruit Chairman Faces Four-Year Term,* JAPAN TIMES, Mar. 30, 2002 (describing the government's case against Hiromasa Ezoe, the chairman of Recruit Co., charged with selling underpriced shares to a cabinet secretary in exchange for political favors to be carried out on Recruit's behalf).

[43] *See supra* note 13.

[44] *See* Randall Smith, *Goldman Gave Hot IPO Shares To Top Executives of Its Clients,* WALL ST. J., Oct. 3, 2002, at A1.

[45] *See* Dan Ackman, *A Harmonic Convergence of Sleaze,* FORBES, Jul. 18, 2002, *available at* http://www.forbes.com/2002/07/18/0718topnews.html.

entitled to allocations from their investment bankers.[46] According to one banker, "[c]lients began to expect it as a condition of giving us their investment-banking work."[47]

This Article focuses on the second form of spinning to corporate insiders – that is, an underwriter's allocation of shares to managers of firms that are *not yet public*. Once again, underwriters can be rewarded in many ways, but the motivation for doing so is clear: "You pay them off and expect you're going to get treated in kind when they do the transaction."[48]

The most obvious way for a pre-IPO manager to return the favor to an underwriter, of course, is to reward that underwriter with a leading role in the firm's offering. Media accounts of spinning have focused primarily on the quid pro quo of future underwriting business.[49] Moreover, a number of investment bankers have discussed the practice in these terms:

> What we're talking about is trying to solicit business. . . . What do you think about taking them out to dinner? . . . We throw lavish parties with caviar. Is that not trying to influence them, their behavior? I suggest that it is. . . . [Spinning is] not illegal. It's not immoral. It's a business decision.[50]

A well-documented recent example of such practices is the "Friends of Frank" account at Credit Suisse First Boston,[51]

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[46] *See* Tom Hamburger et al., *Salomon IPO Deals Provoke Congress: Corporate Malfeasance Probes May Be Expanded*, WALL ST. J., Aug. 29, 2002, at C1.

[47] *Id.* (quoting an investment banker).

[48] *See* Siconolfi, *supra* note 10 (quoting Robert Messih, a managing director at Salomon, Inc., characterizing the banker's mindset generally but claiming that his firm did not engage in spinning).

[49] *See, e.g.*, Michael Siconolfi, *SEC Broadens 'Spinning' Probe to Corporations*, WALL ST. J., Dec. 24, 1997, at C1 (discussing spinning as "an apparent bid to get business from the executives' companies"); Michael Siconolfi, *'Spinning' of Hot IPOs is Probed: U.S. Attorney Begins Criminal Investigation*, WALL ST. J., Apr. 16, 1998, at C1 (portraying spinning as "a potential bid to get future business from the executives' companies").

[50] *See* Siconolfi, *supra* note 10 (quoting Cristina Morgan, a managing director of investment banking at Hambrecht & Quist). Sanford Robertson, chairman of Robertson Stephens, expressed a similar view: "We try to run an honest business. I don't see anything wrong giving a good client a new issue." *Id.*

[51] The account was created by Frank Quattrone, now facing criminal prosecution for obstruction of justice in connection with these activities. *See Executives on Trial: New Quattrone Trial on March 22*, WALL ST. J., Dec. 3, 2003, at C11 (reporting that new trial date has been set after initial mistrial). In addition, the NASD alleges that:

> Quattrone's Tech Group sought to win and retain investment-banking business . . . by 'spinning' IPO shares, for example, giving access to hot IPOs to select corporate executives who could influence their employers' choice of investment bankers. . . . In making presentations to prospective investment

which rewarded corporate managers with IPO allocations for hiring CSFB and punished them, by removing them from the spinning account, for failing to do so.[52] Similarly, small investment banks sought to use spinning to improve their rank within the underwriting syndicate.[53] It should be emphasized, however, that whomever receives the IPO shares, the allocation will generate goodwill only if the shares are sure to appreciate in aftermarket trading – that is, only if the issue is underpriced. From the underwriter's point of view, underpricing is thus an essential element in the design and creation of spinning allocations.

III. UNDERPRICING FROM THE PERSPECTIVE OF THE ISSUER

The last part of this Article showed that underwriters may seek to underprice new issues in order to insure themselves against the risks of a sticky issue and to generate goodwill. Underpricing will be worthwhile to underwriters on the margin provided that the value of the insurance and goodwill generated through underpricing exceeds the commission losses of $0.07 per dollar of underpricing.[54]

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banking clients, the Tech Group held out access to IPO shares as an inducement to the prospective client's officials.

See News Release, National Association of Securities Dealers, Inc., NASD Charges Frank Quattrone with Spinning, Undermining Research Analyst Objectivity, Failure to Cooperate in Investigation (Mar. 6, 2003). *See also* Randall Smith & Susan Pulliam, *Buddy System: How a Technology-Banking Star Doled Out Shares of Hot IPOs,* WALL ST. J., Sept. 23, 2002, at A1. Quattrone has been compared to Michael Milken, the human embodiment of the market collapse and scandal. *See* Peter Elkind & Mark Gimein, *The Trouble With Frank: Frank Quattrone Was the Top Investment Banker in Silicon Valley; Now His Firm Is Exhibit A in a Probe of Shady IPO Deals,* FORTUNE, September 3, 2001, at 112.

[52] According to a former technology analyst at Credit Suisse First Boston: "If you take your company public with Bank X, you will most likely receive shares of Bank X's next 5 . . . deals. So it becomes something of a 'you scratch my back, I will scratch yours.'" *See* Deborah Lohse, *Tech Boom's Hot IPOs May Haunt Valley Execs: 'Spinning' Gets Attention of Regulators,* SAN JOSE MERCURY NEWS, Sep. 28, 2002, at 1 (quoting e-mail of Lise Buyer, but also noting CSFB's response that Buyer did not handle IPOs and that her views may have been the result of news accounts rather than work experience). *See also* Smith & Pulliam, *supra* note 51.

[53] For example, after Needham & Co. allocated 1000 shares of a hot IPO to Alfred Stein, Chairman of VLSI Technology, Stein demanded that the managing underwriters assign Needham & Co. a large allotment of the VLSI offering. A banker for one of the co-managers noted, "[i]f it were left to his doing, he would have paid Needham more than the co-managers." Siconolfi, *supra* note 10.

[54] This Article treats seven percent as the standard underwriter commission. *See supra* note 25.

For issuers, however, the net present value calculation is not the same. Issuers lose $0.93 per dollar of underpricing. Underpricing is thus much more expensive to issuers than it is to underwriters. So why do they do it? The offering price, after all, is the product of a negotiation between the issuer and its underwriter. Why would the issuer agree to sell its shares for less than they are worth?

This Part considers underpricing from the perspective of the issuer. In doing so, it reviews three possible explanations for underpricing. First, underpricing may maximize issuer welfare in some non-obvious way. Second, issuers may underprice because they have been duped by their underwriters. And third, issuers may underprice because their managers have been corrupted by the underwriters. In evaluating these explanations for underpricing, this Part applies insights drawn from the literature of financial economics, which for decades has debated the issues raised by underpricing in IPOs.[55]

A. *Underpricing and Issuer Welfare Maximization*

An issuer that has underpriced its IPO has, by definition, failed to maximize the proceeds raised in its offering. It is therefore hard to imagine how underpricing can be a source of value for an issuer. A theory of underpricing that is consistent with issuer welfare maximization must locate a source of value for the issuer apart from the offering proceeds. Moreover, in order to demonstrate that underpricing is a rational choice for issuers, such a theory must show that this alternative source of value exceeds the loss of the capital foregone in the underpriced offering. Finally, a convincing theory of underpricing as a welfare-maximizing activity on the part of issuers should be able to account for the dramatic increase in underpricing during the bull market of the late 1990s.[56]

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[55] The pioneering work was that of Roger Ibbotson. *See generally* Roger G. Ibbotson, *Price Performance of Common Stock New Issues*, 2 J. FIN. ECON. 235 (1975). Since Ibbotson's work, a proliferation of theories have been developed and tested as explanations for underpricing. *See generally* Roger Ibbotson et al., *Initial Public Offerings*, 1 J. APPLIED CORP. FIN. 37 (1988) (surveying developments); TIM JENKINSON & ALEXANDER LJUNGQVIST, GOING PUBLIC: THE THEORY AND EVIDENCE ON HOW COMPANIES RAISE EQUITY FINANCE (2d ed. 2001) (surveying the literature and offering data across global markets).

[56] *See supra* note 18.

This section considers four prominent theories that portray underpricing as a wealth-enhancing activity for issuers and, after evaluating the support for each, finds that none provides a full account of underpricing from the issuer's perspective, especially in light of the outsized pricing margins observed in the late 1990s.

1. Signaling Effects

Issuers may seek to underprice because they value the jump, or "pop," in their share price from the offering price to the aftermarket price. 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.

Signaling mechanisms are valuable when there is an information asymmetry among the parties to a potential transaction,[57] and information asymmetry is perhaps the greatest challenge facing new firms seeking to raise equity capital. New issuers have private information about themselves, including their business prospects and probable returns on investment, but it is difficult for them credibly to convey this information to outsiders who are justifiably suspicious given the issuer's strong incentives to lie or at least shade the truth in order to raise more capital. Underpricing may thus operate as a signaling mechanism – that is, a means credibly to convey private information about the issuer to a suspicious public.

Underpricing signals may be directed at aftermarket investors, who may reason from a pop in the issuer's share price that other investors have researched the company and deemed it a worthy investment, giving the investor an opportunity to free-ride on others' information gathering.[58]

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[57] *See generally* A. MICHAEL SPENCE, MARKET SIGNALING: INFORMATIONAL TRANSFER IN HIRING AND RELATED SCREENING PROCESSES (1974) (introducing the economics of signaling through the example of a job candidate who, because she is better informed about her capabilities than prospective employers, must find a set of proxies to signal her worth in order to be hired).

[58] In the trading market, price movements are often taken as an indication of investor interest in a particular stock. Because useful company-specific information is difficult and expensive to obtain, aftermarket participants often seek to free-ride on each other's research efforts. Positive price movements, because they indicate that other traders have researched the company and decided to invest, may thus provide less-informed investors with a useful proxy for value. *See generally* Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549 (1984) (describing this mechanism as "price decoding"). Underpricing thus mimics an implicit certification by other investors of the worth of the issuer.

Underpricing may also amplify the effects of the availability heuristic and help to perpetuate the commonly-held view among retail investors that IPO shares are a generally good investment, at least in the short term.[59] In addition to stoking the enthusiasm of aftermarket traders, a pop in the issuer's share price on the first day of trading may send signals to customers and creditors that the issuer is reliable and creditworthy.[60] Aftermarket performance may also have an impact on future equity offerings, in which issuers may seek to recoup the capital foregone in initial underpricing.[61] Finally, the signaling effects of underpricing may also be directed at the financial press and general media in an effort to create

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[59] The availability heuristic suggests that decision-makers tend to draw on those experiences that are most readily available when considering a course of action. A systematic effect of the availability heuristic is the decision-maker's elevation of the significance of memorable low-probability events, such as plane crashes or an IPO appreciating over 200% on its first day of trading. *See generally* Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases, in* JUDGMENT UNDER UNCERTAINTY: HEURISTICS AND BIASES 3 (Daniel Kahneman et al. eds., 1982). Ever increasing investor interest in IPOs may build to an "availability cascade" in which enthusiasm is fed back to the enthusiastic public, amplified, repeated, and recycled again and again into more enthusiasm. *See generally* George A. Akerlof, *The Economics of Caste and the Rat Race and Other Woeful Tales,* 90 Q. J. ECON. 599 (1976) (reputational cascades); Sushil Bikhchandani et al., *A Theory of Fads, Fashion, Custom, and Cultural Change as Informational Cascades,* 100 J. POL. ECON. 992 (1992) (informational cascades). The notion of an "availability cascade" relates the availability heuristic to mass culture:

> [I]dentifiable social mechanisms govern the availability of information; and through the mediation of the availability heuristic, this availability shapes, on the one hand, judgments about the magnitudes of various risks and, on the other, the acceptability of these risks. Simultaneously, the consequent individual actions and expressions affect the availability of information. There are thus two-way interactions between social outcomes and individual cognitive processes. These interactions form an availability cascade whenever individual uses of the availability heuristic increase the public availability of data pointing to a particular interpretation or conclusion, and this increase in availability triggers reinforcing individual responses.

Timur Kuran & Cass R. Sunstein, *Availability Cascades and Risk Regulation,* 51 STAN. L. REV. 683, 712 (1999) (emphasis omitted); *accord* Robert J. Shiller, *Speculative Prices and Popular Models,* 4 J. ECON. PERSP. 55, 61-63 (1990) (describing as the "impressario hypothesis" the view that underwriters use underpricing to create a hot market for IPOs).

[60] *See generally* Carl W. Schneider et al., *Going Public: Practice, Procedure, and Consequences,* 27 VILL. L. REV. 1, 3 (1981) ("A public offering of stock will improve net worth, enabling the company to borrow capital on more favorable terms.").

[61] According to this view, issuers maximize gains in a multi-period game. In period one – the IPO – issuers underprice to signal their value, enabling them to extract higher prices in period two – the subsequent equity offering. *See* Mark Grinblatt & Chuan Yuang Hwang, *Signalling and the Pricing of New Issues,* 44 J. FIN. 393 (1989) (signaling effects from combination of underpricing and managers' retention of equity); Ivo Welch, *Seasoned Offerings, Imitation Costs, and the Underpricing of Initial Public Offerings,* 44 J. FIN. 421 (1989).

publicity for the company, potentially translating into an increase in customers and clients.[62]

Without denying that signaling mechanisms can be of considerable value to issuers, the question remains whether using underpricing as a signal is worth its cost in terms of foregone capital. There are several reasons to believe, in spite of the intuitive appeal of this explanation, that it is not.

First, it is unlikely that issuers underprice their IPOs in order to increase their take in seasoned offerings. Aftermarket pops do not last. Over time, usually within three years, new issues are generally outperformed by comparable existing firms.[63] This is the long term *overpricing* of IPOs.[64] Subsequent issues, when they occur at all, are usually years away, giving the market ample time more accurately to assess the value of the issuer. In this interim period between the initial offering and any subsequent offerings, a wealth of other, more reliable signals regarding the issuer will flood the market, including quarterly earnings disclosures and audited annual financial

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[62] *See* Elizabeth Demers & Katharina Lewellen, *The Marketing Role of IPOs: Evidence from Internet Stocks,* 68 J. FIN. ECON. 413 (2003) (finding that post-IPO growth in web traffic is positively associated with initial aftermarket returns from Internet companies). *See also* Julia Angwin, *Can These Dot-Coms Be Saved?: Profit Eludes Priceline As Expansion Takes Its Toll,* WALL ST. J., Jan. 25, 2001, at B1 (discussing massive pre-IPO media coverage of Priceline.com).

[63] Jay R. Ritter, *The Long-Run Performance of Initial Public Offerings,* 46 J. FIN. 3 (1991) (finding that IPOs significantly underperform comparable firms over a 3 year period and summarizing other studies also finding negative long-run IPO performance). *But see* Paul A. Gompers & Josh Lerner, *The Really Long-Run Performance of Initial Public Offerings: The Pre-Nasdaq Evidence,* 58 J. FIN. 1355 (2003) (demonstrating, over a large sample of firm-commitment IPOs in the United States from 1935-1972, that underperformance depends upon the method of return measurement used and that under some methods underperformance disappears altogether).

[64] *See* Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson,* 89 COLUM. L. REV. 979 (1989).

> New issues are overpriced and underpriced all at the same time, but it is the overpricing that determines the ultimate outcome. The underpricing is a selling technique, one that highlights the very short-term incentives that drive this market.
>
> How can a stock be over- and under-priced all at once? Strong new issue markets are a creature of the late stages of bull markets when investors' wits are dulled, and their appetites whetted, by the prospect of easy money. Some new issues, notably at the beginning of the cycle, represent attractive values, but it is a time when new and untested companies can raise striking sums. So much so that it is often necessary to price their shares as a multiple of sales not earnings. Convergent Technologies, for example, wound up with a market capitalization of almost $600 million, though its gross revenues were only about $13 million.

Id. at 998.

statements. Future creditors and investors are likely to rely on these signals instead and may not even remember the issuer's first day pop.

More fundamentally, most issuers never return to the equity market.[65] This makes underpricing utterly irrelevant as a signal of firm worth in future capital raising exercises, since those exercises are likely never to occur. If the initial public offering is the issuer's only public offering, then there is little sense in building aftermarket enthusiasm as a future marketing technique. Indeed, the empirical evidence generally discredits the relationship between underpricing in the IPO and seasoned equity offerings.[66]

Second, if issuers do not underprice in order to recoup their costs in subsequent offerings, it is unclear whether the signaling effects of underpricing are of any value at all. In order for a signal to convey credible information to the receiver, it must be difficult to imitate falsely.[67] As long as issuers underprice in order to raise more capital in a subsequent offering, imitation costs are high because issuers who certify falsely will be found out before they can raise subsequent rounds of equity and consequently will be unable to recoup the cost of underpricing. However, if as most current evidence suggests, underpricing is unrelated to subsequent equity offerings, the cost of imitation may be reduced. If underpricing is directed towards a more near-term goal, such as immediate

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[65] *See generally* Marcel Kahan, *Securities Laws and the Social Costs of "Inaccurate" Stock Prices*, 1992 DUKE L.J. 977, 1014 (1992) (noting that most companies make a public offering of equity only once and that "public offerings are exceptional occurrences"); Lynn A. Stout, *The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation*, 87 MICH. L. REV. 613, 647 (1988) ("On average, publicly held corporations issue only once every eighteen years . . . .").

[66] *See* Jon A. Garfinkel, *IPO Underpricing, Insider Selling and Subsequent Equity Offerings: Is Underpricing a Signal of Quality?*, 22 FIN. MGMT. 74 (1993) (rejecting positive relationship between underpricing and both probability and amount of seasoned equity offering); Roni Michaely & Wayne H. Shaw, *The Pricing of Initial Public Offerings: Tests of Adverse-Selection and Signaling Theories*, 7 REV. FIN. STUD. 279 (1994) (same). *But see* Narasimhan Jegadeesh et al., *An Empirical Investigation of IPO Returns and Subsequent Equity Offerings*, 34 J. FIN. ECON. 153 (1993) (finding weak evidence to relate underpricing and seasoned equity offerings). Recent evidence also suggests that issuers also underprice subsequent equity offerings, although by a smaller margin than IPOs, further discrediting the argument that issuers use subsequent offerings to recoup the costs of underpricing in the IPO. *See, e.g.*, Shane A. Corwin, *The Determinants of Underpricing for Seasoned Equity Offerings*, 58 J. FIN. 2249 (2003) (finding consistent underpricing for SEOs that is considerably less than that observed for IPOs).

[67] *See* SPENCE, *supra* note 57.

aftermarket enthusiasm and media attention, imitations may not be detected in time to expose them as false and react accordingly. Because it can no longer separate good firms from false imitations, underpricing should be severely devalued as a signal.

Of course, it is still possible that retail investors and the media will place more value on underpricing as a signal than they should, but this does not imply that it is worth it to the issuer to seek to capture that value through underpricing. If retail investors behave truly irrationally, there is no reason to try to signal anything through the offering price because these investors' reactions will, in any event, be unanchored and unpredictable. If, on the other hand, underpricing is somehow connected with investor enthusiasm, issuers will have to weigh the benefit of exploiting that connection against the cost of underpricing. Ultimately, a media strategy based on purchasing prime-time advertising may cost less than one based on underpricing in the IPO.[68] Moreover, since there are a number of other means available to the issuer to certify quality,[69] issuers may find a beneficial signal that is less costly than underpricing.[70]

In sum, signaling effects probably do not explain the phenomenon of underpricing in IPOs. This does not mean that signaling effects are not extremely significant in situations of asymmetric information or that investors, and even some issuers' managers,[71] do not sometimes interpret underpricing as

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[68] Attention from the financial media is not without value to the issuers, but in noisy markets, such as the IPO boom of the late 1990s, the value of fawning by the financial media is diluted by the fawning given to others. A manager's appearance on CNBC sounds great, but the next segment will be devoted to another firm, and in this way the attention given to all issuers degrades the attention given to any one issuer.

[69] Available options include choosing a prestigious underwriter, conducting a firm commitment rather than best efforts offering, and selecting a reputable auditor. *See, e.g.*, Booth & Smith, *Capital Raising*, *supra* note 23 (choice of underwriter as signal); John C. Coffee, Jr., *Understanding Enron: "It's About the Gatekeepers, Stupid,"* 57 BUS. LAW. 1403 (2002) (choice of auditor); Gilson & Kraakman, *see supra* note 58 (role of investment bankers); Glenn A. Wolfe et al., *supra* note 23 (finding that prestigious underwriters avoid smaller, riskier issues).

[70] Some evidence suggests that a choice of a prestigious underwriter may *save* the issuer money on underpricing. *See* Richard B. Carter et al., *Underwriter Reputation, Initial Returns, and the Long-Run Performance of IPO Stocks*, 53 J. FIN. 285 (1998) (associating underwriter prestige with less short term underpricing and better long term performance). *But see infra* note 152 and accompanying text (finding that high prestige underwriters also engaged in underpricing during the IPO boom).

[71] Ryan and DeGraw polled the CFOs of newly public firms on their attitudes regarding the offering process, conducting samples in both 1998 and 2002, and found in the 2002 sample that over 70% of respondents agreed or strongly agreed with the

a signal. The counter-evidence suggests only that the benefits of underpricing as a signal are highly uncertain. Weighed against this uncertain benefit, however, are the certain costs of the practice – that is, the foregone capital that the offering would otherwise have brought into the issuer's treasury.[72] Is it really plausible that in 1999, for example, issuers would have agreed to $27 billion worth of underpricing for the sake of uncertain signaling effects? Rational issuers confronting certain costs and uncertain benefits are likely to seek other alternatives.

2. Lawsuit Avoidance

Issuers might underprice in order to discourage investor litigation in the event that problems with the company are subsequently revealed. The lawsuit-avoidance hypothesis asserts that underpricing is a source of value for issuers and underwriters because it enables them to reduce litigation costs.[73] Building on the fact that under Section 11 of the Securities Act of 1933 liability for errors or omissions in a registration statement cannot exceed the proceeds of the offering,[74] the lawsuit-avoidance hypothesis argues that

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statement that "high first day returns are necessary to gain interest in the IPO." *See* Patricia A. Ryan & Irv DeGraw, *A Brief Comparison of the Oct 2000-June 2002 IPO CFO Results to the 1996-1998 IPO CFO Results* (working paper, on file with author), tbl.7 [hereinafter Ryan & DeGraw, *2002 Study*]; Patricia A. Ryan & Irv DeGraw, *Evidence From Chief Financial Officers Regarding the IPO Process: 1998 Study* (working paper, on file with author) [hereinafter Ryan & DeGraw, *1998 Study*].

[72] *See* Michel A. Habib & Alexander P. Ljungqvist, *Underpricing and Entrepreneurial Wealth Losses in IPOs: Theory and Evidence,* 14 REV. FIN. STUD. 433 (2001) (modeling optimal issuer behavior with respect to underpricing and arguing that issuers who seek to reduce underpricing will do so up to the point where the marginal cost of reducing underpricing equals the marginal benefit).

[73] *See* Seha M. Tinic, *Anatomy of Initial Public Offerings of Common Stock,* 43 J. FIN. 789 (1988) (arguing that underwriters and issuers have incentives to underprice in order to reduce the probability that investors will bring a lawsuit as well as the probability and magnitude of an adverse judgment).

[74] *See* Securities Act of 1933, § 11(e), 15 U.S.C. § 77k(e) (2000) [hereinafter Securities Act] (defining damages as the difference between the amount paid for the security, not to exceed the price at which the security was offered to the public, and the value of the security when sold or, if not sold, when the suit was filed).

underpricing may be used as a strategy to mitigate securities law liability by limiting the proceeds of the offering.[75]

The lawsuit avoidance hypothesis, however, has been largely discredited.[76] The strength of its central insight, tying liability under the Securities Act to offering proceeds, is not as great as it may initially seem because (1) legal liability under Section 10(b) of the Exchange Act is tied to the price at which the plaintiff bought the security *regardless of the offering price*[77] and (2) claims are likely to be brought under both Acts.[78] As a result, the underpricing of an offering is not likely to deter plaintiffs, who will nevertheless be able to bring Exchange Act claims.[79] In fact, IPO litigation does not correlate well with IPO pricing,[80] and settlement practices suggest that underwriters have very little to gain from underpricing as a means of avoiding legal liability.[81] Moreover, underpricing persists in capital markets worldwide, most of which threaten the issuer with significantly less litigation risk than U.S. securities laws do.[82]

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[75] *See* Patricia J. Hughes & Anjan V. Thakor, *Litigation Risk, Intermediation, and the Underpricing of Initial Public Offerings,* 5 REV. FIN. STUD. 709 (1992) (arguing that underpricing is undertaken by "non-myopic" underwriters to reduce the direct and indirect costs of litigation). *See also* JENKINSON & LJUNGQVIST, *supra* note 55, at 111-12 & tbl.4.1 (summarizing the testable implications of the theory and the empirical results).

[76] Professor Alexander was one of the earliest and most forceful critics of this hypothesis. *See* Janet Cooper Alexander, *The Lawsuit Avoidance Theory of Why Initial Public Offerings are Underpriced,* 41 UCLA L. REV. 17 (1993).

[77] Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78j(b) (2000) [hereinafter Exchange Act]; 17 C.F.R. § 240.10b-5 (2002).

[78] Alexander, *supra* note 76, at 34.

[79] More basically, Professor Alexander points out that "there is no legal basis for suing because a security was priced too high – either in the sense that the open-market price was lower than the offering price, or that the offering price was higher than the 'intrinsic' value." *Id.* at 35. A decline in price may increase the risk of being sued, as it does for all corporations with a keen following among the plaintiffs' bar, but the price decline has absolutely no relationship to the probability that liability will be found, contrary to the assumptions of the lawsuit avoidance hypothesis.

[80] *Id.* at 42. *But see* Michelle Lowry & Susan Shu, *Litigation Risk and IPO Underpricing,* 65 J. FIN. ECON. 309 (2002) (testing lawsuit avoidance hypothesis and finding that firms with higher litigation risk underprice more).

[81] *See* Alexander, *supra* note 76, at 48 (noting that settlements are likely to be paid from the issuer's directors and officers liability insurance policy and that underwriters "hardly ever have to pay" largely because of indemnification provisions in the underwriting agreement).

[82] *See* JENKINSON & LJUNGQVIST, *supra* note 55, at 113 (noting that "underpricing is a global phenomenon, while strict liability laws are not" and summarizing the conclusions of studies finding underpricing in the absence of serious liability risk in non-US markets). *See also* Alan L. Beller et al., *Looks Can Be Deceiving: A Comparison of Initial Public Offering Procedures Under Japanese and U.S. Securities Laws,* 55 L. & CONTEMP. PROB. 77 (1992) (finding underpricing in Japan

Because underpricing has, at best, a tenuous correlation with legal liability, underwriters and issuers would probably be better off simply pricing the offering to demand and paying the expected value of legal liability rather than underpricing the offering in hopes of mitigating legal costs.[83]

3. Correcting Adverse Selection

Issuers may underprice to keep less informed investors interested in IPOs. This theory of underpricing – the adverse selection hypothesis – is rooted, like the signaling model, in an information asymmetry in the offering process.[84] However, unlike signaling models that focus on the information asymmetry *between issuers and investors*, the adverse selection hypothesis focuses on an information asymmetry *among investors*.

The adverse selection hypothesis begins by assuming a model in which most market participants – including the issuer, the underwriter, and most investors – are uninformed about the true value of the issuer's stock, while others have perfect information.[85] The assumption of an investor with perfect information is meant "[t]o emphasize the informational advantage which the market enjoys over the firm and the underwriter."[86] From this set of assumptions, the model

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without an economically significant risk of legal liability); T.J. Jenkinson, *Initial Public Offerings in the United Kingdom, the United States, and Japan,* 4 J. JAPANESE & INT'L ECON. 428 (1990) (same, UK); Roger M. Kunz & Reena Aggarwal, *Why Initial Public Offerings are Underpriced: Evidence from Switzerland,* 18 J. BANK. & FIN. 705 (1994) (same, Switzerland); Phillip J. Lee et al., *Australian IPO Pricing in the Short and Long Run,* 20 J. BANK. & FIN 1189 (1996) (same, Australia).

[83] Alexander, *supra* note 76, at 59 (reporting the results of a study incorporating generous estimates of litigation costs, including attorneys fees and expenses, and a relatively conservative underpricing estimate, 9.87%, that finds estimated total losses of securities law liability to be 23.37% less than the cost of underpricing); *accord* Philip D. Drake & Michael R. Vetsuypens, *IPO Underpricing and Insurance Against Legal Liability,* FIN. MGMT., Spring 1993, at 64-73 (independently verifying Professor Alexander's findings and arguing that "underpricing the IPO is not a very efficient way of avoiding future lawsuits").

[84] As an explanation for underpricing, the adverse selection hypothesis can be traced to Kevin Rock. *See* Kevin Rock, *Why New Issues Are Underpriced,* 15 J. FIN. ECON. 187 (1986).

[85] *See id.* at 190 (noting that the issuer and the underwriter give up whatever information advantage they might have had through their securities law disclosures and their estimate of an appropriate offering price).

[86] *Id.* Rock repeatedly emphasizes the informational advantage of the market, noting that "even though the firm and its agent know more than any single individual in the market, they know less than all the individuals in the market combined" and that "the firm and its banker are at a considerable informational

portrays IPOs in the absence of underpricing as a market for lemons.[87] Because some investors are well informed relative to others, better-informed investors will subscribe only to offerings of quality firms priced as a bargain, leaving less-informed investors with the leftovers – that is, shares of poor quality, overpriced firms. Over time, this adverse selection process would teach less-informed investors a lesson: Do not invest in IPOs.[88]

This is not a lesson that issuers and underwriters are eager to teach since they may need less-informed investors to sell offerings. On the whole, therefore, issuers and underwriters would prefer to discount all IPOs, even those of quality firms, in order to prevent uninformed investors from being disproportionately harmed and therefore chased from the market.[89] Uninformed investors, even if they continue to receive systematically more low-quality issues than high-quality issues, at least will no longer risk earning a negative return from their IPO investments since all offerings are priced below their aftermarket trading price. By underpricing all offerings, uninformed investors can be kept in the market for new issues.

The first item to note in connection with the adverse selection hypothesis is that it raises an interesting collective action problem. The harm of adverse selection is borne by the imaginary collectivity of issuers as a whole, while the rewards of overpricing benefit individual issuers directly. While it may be true that issuers maximize their *collective* welfare by underpricing to guarantee the continued participation of uninformed investors, individual firms make initial public offerings only once and subsequent equity offerings rarely, if ever.[90] As a result, these firms could maximize their *individual*

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disadvantage relative to the market as a whole." *Id.*

[87] *See generally* George A. Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism,* 84 Q. J. ECON. 488 (1970) (developing the adverse selection model in the context of a used car market where buyers are at an informational disadvantage with respect to sellers, which will lead to their receipt of systematically lower quality cars, "lemons," and ultimately their withdrawal from the used car market unless sellers provide some accommodation, such as a warranty or return policy or deep price discount).

[88] *See* Rock, *supra* note 84, at 188 ("If an investor finds that he receives none of the underpriced issues . . . and all of the overpriced issues . . . [then he] does not participate in the new issue market . . . .").

[89] *See id.* at 193 ("[T]o attract uninformed investors to the offering, the issuer must price the shares at a discount, which can be interpreted as compensation for receiving a disproportionate number of overpriced stocks.").

[90] *See supra* note 65 and accompanying text.

welfare by defecting from the collectively optimal regime and pricing their offering as close to actual demand as possible. Moreover, because all issuers will face these same incentives, defection should become the dominant outcome, ultimately causing the exit of the uniformed investor.[91]

Fortunately, underwriters have different incentives in this situation. Though they generally are not an unusually self-sacrificing bunch, underwriters, unlike issuers, are repeat players in the equity markets. Because their next offering may be one in which the participation of uninformed investors is needed, underwriters will be more eager to guarantee the future participation of uninformed investors.[92] If the adverse selection hypothesis is correct, underwriters' pricing decisions must respond both to the interests of uninformed investors, who require underpricing, and issuers, who prefer to price to demand in order to maximize the proceeds of their offering.[93] This may account for the consistency of underpricing and its tendency, in most markets, to be set within a fairly narrow range of between ten and fifteen percent below the aftermarket trading price.[94]

A deeper problem with the adverse selection hypothesis, however, lies in the basis of its foundational assumptions

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[91] The situation thus becomes a "social dilemma" – that is, a game-theoretic situation in which the interests of the individual conflict with the interests of the collectivity. The most familiar of these is the "prisoner's dilemma," but other terms are commonly applied to the same general problem, including "social traps," the "tragedy of the commons," and "public goods/free riding problems." *See, e.g.*, Toshio Yamagishi, *The Structural Goal/Expectation Theory of Cooperation in Social Dilemmas*, 3 ADVANCES IN GROUP PROCESSES 51, 53-57 (1986) (noting the many names under which the general problem of individual/group conflict may be described).

[92] *See* R.P. Beatty & J. R. Ritter, *Investment Banking, Reputation, and the Underpricing of Initial Public Offerings*, 15 J. FIN. ECON. 213 (1986) (providing data to support the proposition that underwriters may lose future business if they fail to underprice offerings).

[93] *See* Richard Carter & Steven Manaster, *Initial Public Offerings and Underwriter Reputation*, 45 J. FIN. 1045, 1049 (1990) ("The uninformed investors will only participate . . . if the expected value of participation is greater than or equal to zero . . . . Therefore, [the issuing firms and underwriters] will set the offer price such that the expected return to the uninformed investors is exactly zero."); Craig G. Dunbar, *Factors Affecting Investment Bank Initial Public Offering Market Share*, 55 J. FIN. ECON. 3 (2000) (finding that underwriters lose equity offering market share if they underprice or overprice to excess); Vikram Nanda & Youngkeol Yun, *Reputation and Financial Intermediation: An Empirical Investigation of the Impact of IPO Mispricing on Underwriter Market Value*, 6 J. FIN. INTERMEDIATION 39 (1997) (correlating overpricing with *decreases* in the underwriter's own share price, but failing to find any such correlation for substantial underpricing, and finding that moderate underpricing *increases* the underwriter's share price).

[94] *See* Loughran & Ritter, *Money on the Table*, *supra* note 17, at 433.

regarding information. The model assumes: (1) whether an issue will be a winner or a loser is knowable ex ante, (2) that there is a piece of information capable of conveying this fact, and (3) that some human being actually knows it. A skeptic, however, might well ask exactly which piece of data will accurately convey the success or failure of an investment opportunity.[95] And indeed, although financial economists have tested the correlation of numerous types of information with the "value" of an issue,[96] they have been generally unable to find a piece of information that can reliably sort winners from losers.[97]

It is possible, in other words, that the problem is not the non-disclosure of such information, but rather its non-existence. Even the price of a security in an efficient market does not imply that all participants agree on the security's value.[98] Markets are aggregating mechanisms. Market prices represent the blended decision making of all participants, leaving plenty of room for them to disagree over the import of various pieces of information and their relationship to value. The information that is impounded in market price may reflect investors "anticipating what average opinion expects the average opinion to be"[99] more than it reflects investors' views

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[95] *See* Royce de R. Barondes, *Adequacy of Disclosure of Restrictions on Flipping IPO Securities,* 74 TUL. L. REV. 883, 892 n.48 (arguing that, contrary to the assumptions of the adverse selection hypothesis, crucial information regarding the issuer's prospects is generally not available to investors in IPOs).

[96] These have included the maturity of the issuer, aggregate offering proceeds, offering price, underwriting fees, and underwriter prestige. *See* E. BLOCH, INSIDE INVESTMENT BANKING ch.9 (1989) (underwriting fees); Beatty & Ritter, *supra* note 92, (offering proceeds); Michael J. Brennan & Patricia J. Hughes, *Stock Prices and the Supply of Information,* 46 J. FIN. 1665 (1991) (offering price); Carter & Manaster, *supra* note 93 (choice of underwriter); Habib & Ljungqvist, *supra* note 72 (underwriting fees); Jay R. Ritter, *The "Hot Issue" Market of 1980,* 57 J. BUS. 215, 223, 237 (1984) (suggesting that how well "established" a firm is – including such considerations as the age of the firm, the book value of its equity, and its annual sales – is a proxy for value and finding that there is more underpricing of less well-established firms and less underpricing for better-established firms); Jay R. Ritter, *The Long Run Performance of Initial Public Offerings,* 46 J. FIN. 3 (1991) (testing issuer age and other factors); Sheridan Titman & Brett Trueman, *Information Quality and the Valuation of New Issues,* 8 J. ACCT. & ECON. 159 (1986) (choice of underwriter).

[97] If there was a piece of data that could reliably sort winners and losers, all rational investors would be sure to learn it, which would destroy the foundational assumption of information asymmetry.

[98] This understanding of market efficiency follows the basic definition that the price of a security in an efficient market equals the price it would have if all market participants had the same information, but not necessarily the same wealth or preferences. *See* William H. Beaver, *Market Efficiency*, 56 ACCT. REV. 23, 27 (1981).

[99] JOHN M. KEYNES, THE GENERAL THEORY OF EMPLOYMENT, INTEREST AND MONEY 156 (1936) (providing the now-famous metaphor of market prices as beauty

regarding a firm's "fundamental value."[100] Market analysts are thus like Wilde's cynics – they know the price of everything, but the value of nothing.[101]

If no one knows the "value" of a new issue – that is, if it is impossible to tell a good issue from a bad issue – then there is no adverse selection problem. All new issues are potential losers. All investors are ill informed. And investors who are otherwise relatively sophisticated will join those who are generally unsophisticated in demanding an across-the-board discount before they will buy.[102] Although this is the same outcome predicted by the adverse selection hypothesis, the supporting basis is significantly different. There is no information asymmetry among investors. Instead, there is a degree of parity among investors – to overstate slightly, nobody knows anything about the value of the new issue – and as a result, the across-the-board discount on IPO shares is as much for relatively well-informed investors as it is for ill-informed investors.

Even if there is relative informational parity among investors with respect to the value of an issue, investors may be better informed than issuers and underwriters with respect to their own idiosyncratic valuation of the issue. This information asymmetry is the focus of the next section.

4. Rewarding Investor Disclosure

Issuers may underprice to provide investors with an incentive to behave honestly when they express interest in the issue. This is the insight of the investor-reward hypothesis,[103]

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contest voting to show that the price reflecting supply and demand may be many degrees removed from anyone's view regarding true value).

[100] *See generally* William K.S. Wang, *Some Arguments That the Stock Market is Not Efficient,* 19 U.C. DAVIS L. REV. 341 (1986) (emphasizing James Tobin's distinction between "fundamental value" efficiency and "information arbitrage" efficiency). *See also* Jeffrey N. Gordon & Lewis A. Kornhauser, *Efficient Markets, Costly Information and Securities Research,* 60 N.Y.U. L. REV. 761 (1985) (tracking this distinction but defining the terms as "allocative efficiency" and "speculative efficiency").

[101] OSCAR WILDE, LADY WINDERMERE'S FAN act I (Methuen 1985) (1892) ("A cynic is a man who knows the price of everything but the value of nothing.").

[102] *See* Hanley & Wilhelm, *supra* note 9, at 247 (1995) (finding empirical evidence showing that "institutional holdings appear to be largely independent of the degree to which an issue is underpriced").

[103] Benveniste and Spindt are credited with first emphasizing these elements in connection with underpricing in modeling what I am referring to as the "investor-reward" hypothesis. *See* Lawrence M. Benveniste & Paul A. Spindt, *How Investment Bankers Determine the Offer Price and Allocation of New Issues,* 24 J. FIN. ECON. 343 (1989) [hereinafter Benveniste & Spindt, *Offer Price and Allocation*].

which is closely related to certain aspects of the adverse selection hypothesis. Unlike the adverse selection model, however, the investor-reward hypothesis does not require the assumption that some investors have superior information concerning the *prospects* or *value* of the issuer. Under the investor-reward hypothesis, even investors who are completely unaware of the fundamental value of the issuer still possess a significant piece of information – that is, their own level of demand for the issuer's shares. The investor-reward hypothesis focuses on two critical aspects of the underwriting process: (1) the book-building process, and (2) the role of institutional investors.

After filing the registration statement with the SEC, the underwriter begins to market the issue, pitching it in road show presentations to major investors, primarily institutions, and seeking to build a book of orders through buyers' indications of interest.[104] At the outset of this process, the price of the offering is estimated within a rough range and filed with the SEC. By the end of this process, however, the underwriters will have built a book of tentative orders reflecting each investor's interest in a number of shares at a particular price from which the lead underwriter will be able to gauge the level of demand for the issue and thereby arrive at a more accurate offering price that may be set within or outside of the estimated range.[105]

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[104] Securities law prohibitions restricting offers of the security no longer apply once the registration statement has been filed. *See* Securities Act § 5(c), 15 U.S.C. § 77e(c) (2000). However, because sales of the security cannot be made until the registration statement is effective, the expressions of prospective buyers, whether they are treated as mere indications of interest or offers to buy, are not binding and may be rescinded until the registration statement is declared effective. *See* Securities Act § 5(a), 15 U.S.C. § 77e(a) (2000).

[105] *See* Ed McCarthy, *Pricing IPOs: Science or Science Fiction?*, J. OF ACCT. 51, 55 (Sept. 1999) (quoting an equity analyst's explanation of the road show: "The brokers explain the offering and learn how many shares the institutions would take at various prices – like sketching out a demand curve. The firms' top retail brokers also contact their best clients to learn where the demand is with those investors."). The means by which the underwriter arrives at the recommended price has been described as part art, part science: "The scientific part of the pricing equation is based on numbers: an issuer's historical and projected financial results, as well as valuations for comparable companies. The art is in the investment banker's assessment of market conditions and investors' demand for the new issue." *Id.* at 52. Popular or oversubscribed issues may result in an upwards adjustment of the file range. *See* Samuel N. Allen, *A Lawyer's Guide to the Operation of Underwriting Syndicates*, 26 N.E. L. REV. 319 (1991).

> If there is great enthusiasm for the issuer's securities during the marketing stage of the offering, the public offering price will increase. If the market does not receive the offering favorably, the public offering price will be reduced or the number of shares being offered will be reduced to create greater demand.

The accuracy of this process may be compromised by investors' own strategic behavior. If investors know when they are brought into the road show conference room that their expressions of interest in the issuer will be used to set the price they will eventually pay for the issuer's shares, they will face strong incentives to curb their enthusiasm.[106] If, for example, an investor is actually willing to pay twenty dollars per share for an issue that the underwriter has tentatively priced in the ten to twelve dollar range, the investor is unlikely to reveal her true reservation value to the underwriter and hope, instead, for an allocation at a price set somewhere within the initial file range.[107] Because all investors face similar incentives, we can expect them systematically to express less than complete enthusiasm for the issue, resulting perhaps in an offering price of twelve dollars, but not twenty dollars. Such strategic withholding of investor preferences during the book-building process can prevent issuers from maximizing capital raised in the offering.

Fortunately for issuers, underwriters have some leverage in the book building process. Most basically, the underwriter can reward honesty and punish dishonesty. Underwriters can increase allocations to reward investors who bid high. They can also punish investors who submit low-ball bids by cutting their allocation in the issue and, in extreme cases, excluding them from the future pipeline of offerings. The allocation mechanism thus enables underwriters to check the

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Id. at 346. *See also* Hanley, *supra* note 32 (noting that greater than anticipated demand results in increases from the file range, but not an increase up to the level of aftermarket demand, resulting in the "partial adjustment" phenomenon, a form of underpricing); Laurie Krigman et al., *Why Do Firms Switch Underwriters?*, 60 J. FIN. ECON. 245 (2001) (arguing that in their decision to switch underwriters, firms pay closer attention to the amount of proceeds raised relative to the mid-point of the file range rather than overall underpricing). A foresightful underwriter may be able to take advantage of the "anchoring" heuristic by setting an intentionally low file range. *See generally* Amos Tversky & Daniel Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCI. 1124, 1128-30 (1974) (discussing "adjustment and anchoring").

[106] *See* Benveniste & Spindt, *Offer Price and Allocation*, *supra* note 103, at 344.

> The basic difficulty facing an underwriter wishing to collect information useful to pricing an issue is that investors have no incentive to reveal positive information before the stock is sold. By keeping such information to themselves until after the offering, investors can expect to benefit; they would pay a low initial price for the stock and then could sell it at the full information price in the postoffering market.

Id.

[107] The numerical examples used throughout this section are adapted from JENKINSON & LJUNGQVIST, *supra* note 55, at 91-92.

veracity of investors' indications of interest. In order for this lever to work, however, investors must be repeat players and the expected aftermarket return of all offerings must be positive.[108]

Institutional investors solve the repeat player problem but, at the same time, create the pricing problem. Institutional investors are, in many ways, an underwriter's best friend. With their large reserves of investment capital, institutions enable underwriters to unload shares – i.e., risk – in much larger chunks than they could by selling to retail investors.[109] Moreover, institutional investors are consistent market participants, constantly in search of profitable investment opportunities. They are, therefore, the center of attention at road show presentations and the overwhelming focus of the underwriter's book-building efforts. Because they will keep coming back for more, institutional investors are more susceptible to the system of rewards and punishments that underwriters employ through their allocation decisions.

Nonetheless, in order for this system to work, the aftermarket return of offerings must be positive. Institutions will not invest in losers, and more broadly, will not be interested in IPOs on the whole unless they offer better returns than the institution's other investment options. In this regard, it is important to remember that IPOs underperform in the long term and are relatively poor investments overall.[110] Maybe some retail investors and day-traders are unaware of this fact, but institutions, with their staffs of professional investment advisors, should know it well. New companies are risky investments. They have short histories, unproven business plans, and no record of profitability. The underwriter may seek

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[108] *See* Benveniste & Spindt, *Offer Price and Allocation*, *supra* note 103, at 345.

> Investors who regularly are given priority in IPO allocations by an investment banker earn abnormal returns. This gives the investment banker a lever – namely, the threat to reduce an investor's allocation priority in the future – that can be used to induce regular investors to be forthright with their information in the premarket.

Id.

[109] It may also be easier for underwriters to detect and deter unwanted flipping by an institution rather than an individual due to the institution's size and dependence on future allocations. *See, e.g.*, Wirth, *supra* note 9 (describing system to permit underwriting syndicate to track aftermarket trades and noting that "issuers and their investment banks detest flippers because they can cause chaos in the aftermarket . . ."). *See also* Hanley & Wilhelm, *supra* note 9.

[110] *See supra* notes 63-64 and accompanying text (discussing long term overpricing).

to certify quality,[111] but promises alone cannot make long-term losers into short-term winners. Institutional investors may simply stay away.[112]

According to the investor-reward hypothesis, underpricing keeps institutional investors interested in IPOs. If underwriters can guarantee repeat players a positive average return by pricing IPO shares below aftermarket demand, the underwriters can be sure that the investors will return for more and, just as importantly, that the investors will be susceptible to the system of rewards and punishments embedded in the allocation process. In this way, although it results in leaving money on the table, underpricing may be more valuable to issuers than a system that leaves repeat players indifferent to underwriters' allocation decisions. Returning to the example above, if an investor values an issue at twenty dollars, the underwriter may be able to induce her to reveal her honest enthusiasm if the investor understands that: (1) whatever aggregate demand, she will receive shares at a discount, e.g., twenty percent, and (2) she will get a greater allocation of the underpriced issue by bidding higher and standing by her commitment.[113] The offering may thus be priced at sixteen dollars. When aftermarket demand is revealed at twenty dollars, this offering price earns the issuer four dollars over the initial file range, even though it left another four dollars on the table. Everyone comes out ahead.[114]

The investor-reward model has considerable intuitive appeal, and it has several testable implications that have yielded empirical support. Studies have found that the presence of regular investors and repeat play reduces the amount of underpricing necessary to sell an issue.[115] Findings

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[111] *See supra* note 23 (discussing certification function).

[112] Reliable, relevant information such as a proven history of cash flows or earnings is simply unavailable at this stage in the company's life. For this reason some investment professionals, including Warren Buffett, avoid initial public offerings altogether. *See generally* Lawrence A. Cunningham, *The Essays Of Warren Buffet: Lessons for Corporate America*, 19 CARDOZO L. REV. 5, 15-16 (1997) (describing Buffett's investment approach, which generally involves avoiding IPOs for the inability to research fundamentals).

[113] In spite of the fact that indications of interest are legally non-binding, it is likely that investors who do not fulfill their preoffering commitments will be punished in the same fashion as strategic bidders – that is, by being locked out of future allocations. *See supra* note 108 and accompanying text.

[114] Or, more formally, this is a Pareto superior outcome. *See generally* SAMUELSON & NORDHAUS, *supra* note 22, at 148-49, 266 (discussing Pareto efficiency).

[115] Ann E. Sherman, *IPOs and Long-Term Relationships: An Advantage of Book Building*, 13 REV. FIN. STUD. 697 (2000). *See* also Ann E. Sherman & Sheridan

also support that institutional investors capture a large portion of the rewards associated with hot IPOs and that, in exchange, underwriters are able to call upon institutional investors to participate in cold offerings as well.[116] Empirical evidence also suggests, consistent with the investor-reward hypothesis, that the offering price of issues revealed as hot during the book-building phase is often adjusted upwards, above the file range, but not all the way to aftermarket demand.[117] This "partial adjustment" phenomenon has been documented from 1980 through 2001.[118]

In spite of the appeal of the investor-reward hypothesis, two concerns limit its ability to explain IPO underpricing in the bull market of the late 1990s. First, underpricing margins seem much greater than the hypothesis would imply. In the investor-reward model, each individual institutional investor contributes a relatively small piece to the overall pricing puzzle. Investors do possess information that is relevant to the overall demand for the security, but their information is only relevant to the level of their own idiosyncratic demand, which is only useful when it is blended and weighed with the revealed demand of many other institutions. Because each institution's contribution is relatively small, the reward necessary to induce this contribution should, it would seem, be correspondingly small. Underpricing may thus be necessary, but this would be a relatively narrow band of underpricing. Instead, average underpricing exceeded seventy-one percent in 1999 and fifty-six percent in 2000.[119] Investors seem to be getting more reward than they deserve.

Titman, *Building the IPO Order Book: Underpricing and Participation Limits with Costly Information*, 65 J. FIN. ECON. 3 (2002) (modeling the degree of underpricing necessary to compensate investors for revealing information).

[116] *See* Hanley & Wilhelm, *supra* note 9.

[117] Hanley, *supra* note 32, at 233 (finding that "underwriters prefer to compensate investors for truthfully revealing information by allocating a smaller number of highly-underpriced shares rather than a larger amount of slightly-underpriced shares").

[118] *See* Jay R. Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. FIN. 1795, 1805 (2002) [hereinafter Ritter & Welch, *Review*] ("When the offer price exceeds the maximum of the original file price range, the average underpricing of 53 percent is significantly above the 12 percent for IPOs priced within their filing range, or the 3 percent for IPOs adjusting their offer price downward.").

[119] *See* Jay R. Ritter, *Some Factoids About the 2002 IPO Market,* at 4 tbl.3 (Jan. 2003) [hereinafter Ritter, *Factoids*] (finding average underpricing of 71.7% in 1999 and 56.1% in 2000), *available at* http://bear.cba.ufl.edu/ritter/work_papers/IPOs2002.pdf. Average underpricing for issuers making a partial adjustment from the initial file range was even higher, approaching 53% overall and reaching 119% in 1999-2000. *See* Ritter & Welch, *Review*, *supra* note 118, at 1806

Second, in hot *markets* – as opposed to hot *issues* – underpricing should be at its smallest. A "hot issue" refers to an individual firm that is discovered, through the book-building process, to have generated significant investor demand. A "hot market" refers to a trading climate in which many issues are hot. The investor-reward hypothesis suggests that underpricing should be most pronounced for sporadic hot *issues*, where investor demand is not immediately apparent, but least pronounced in hot markets, where everyone knows investors have considerable enthusiasm for IPOs. Contrary to this reasoning, however, underpricing is often most pronounced in hot markets, as it was during the hot market of the late 1990s,[120] where hyperbolic underpricing seemed to abound.[121]

In this way, although the investor-reward hypothesis may explain consistent and narrow underpricing, it does not explain the outsized underpricing frequently observed in hot markets. Indeed, none of the issuer-welfare explanations can explain the underpricing observed in the bull market of the late 1990s.

B. *Agency Costs of Underwriting*

Given the difficulty of explaining underpricing as a welfare-enhancing activity for issuers, it is perhaps worth asking whether issuers are simply being cheated. There is, after all, a significant divergence between issuer and underwriter interests in the offering and ample incentive for underwriters to underprice the issuer's shares.[122]

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tbl.III.

[120] Calling the IPO market of the late 1990s merely "hot" now seems to understate what Alan Greenspan famously referred to as "irrational exuberance" and what many have acknowledged as a "bubble." *See generally* ROBERT J. SHILLER, *supra* note 1 (studying investor irrationality); Ritter & Welch, *Review*, *supra* note 118, at 1807 ("During the bubble, the IPOs of many Internet firms were the easiest shares ever to sell because of the intense interest by many investors.").

[121] *See* Jay R. Ritter, *Big IPO Runups of 1975-September 2002* (compiling data from CNNfn, Yahoo!, Securities Data Co., and Bloomberg) [hereinafter Ritter, *IPO Runups*], *available at* http://bear.cba.ufl.edu/ritter/RUNUP750.pdf (last visited Feb. 1, 2004), noting:

> The ten biggest first-day percentage increases are: the Va Linux 12/09/99 697.50%, Globe.com 11/13/98 606%, Foundry Networks 9/28/99 525%, Webmethods 2/11/00 507.50%, Free Markets 12/10/99 483.33%, Cobalt Networks 11/05/99 482%, MarketWatch.com 1/15/99 474%, Akamai Technologies 10/29/99 458%, Cacheflow 11/19/99 426.56% and Sycamore Networks 10/22/99 386%.

Id. at 1.

[122] *See supra* Part II.

Allowing these differences in interests and incentives back into the analysis opens the way for a consideration of underpricing in terms of agency costs. In a principal-agent model, the imperfect matching of incentives and the inability of the principal fully to monitor the agent may lead the agent to defect from serving the principal's interests.[123] In the context of a securities offering, the issuer is the principal, offering its shares through the services of an agent, the underwriter, who appropriates the principal's wealth through underpricing. The principal-agent model offers a plausible explanation for underpricing insofar as the issuer cannot perfectly monitor the activities of its agent.

Asymmetries of information and sophistication between the underwriter and the issuer may undermine the issuer's ability to monitor the underwriter. Underwriters recommend an offering price on the basis of the information they gather during the book-building process. Moreover, underwriters have complete control over this information, giving them a significant informational advantage over the issuer.[124] Because the underwriter thus has more price-relevant information than the issuer, the underwriter is likely to have greater leverage in the pricing negotiations.[125]

In addition to information asymmetries, differing degrees of financial sophistication may also give underwriters an edge in the price negotiations. Pricing data is likely to be presented to the issuer as the product of a complex valuation analysis,[126] employing sophisticated financial analyses familiar to investment bankers but unfamiliar to the twenty-four year old founders of an Internet start-up.[127] Underwriters may then

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[123] *See generally* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976) (applying agency theory to the relationship of participants in the corporate entity).

[124] *See, e.g.*, David P. Baron & Bengt Holmstrom, *The Investment Banking Contract for New Issues Under Asymmetric Information: Delegation and the Incentive Problem*, 35 J. FIN. 1115, 1119 (1980).

[125] *See* David P. Baron, *A Model of the Demand for Investment Banking Advising and Distribution Services for New Issues*, 37 J. FIN. 955, 975-76 (1982) ("[I]f issuers . . . are less well informed about the capital market, [they will] have a greater demand for the advising function of an investment banker [and] be willing to accept a lower price the greater is their uncertainty about the market demand for the issue.").

[126] *See supra* note 96.

[127] *See generally* E-DREAMS (Wonsuk Chin & Sam Pai, Cinema Forever, 2001) (documentary chronicling the rise and fall of Kozmo.com and its young founders); START-UP.COM (D.A. Pennebaker, Artisan Entertainment, 2001) (same, focusing on GovWorks.com).

propose an offering price as the result of this supposedly precise and rigorous process, pushing issuers to adopt their price recommendation as the one and only answer to the pricing formula.

Of course, the underwriter's price analysis is no more scientific than a car salesman's price on a used Toyota. The outcome is easily manipulable depending upon the assumptions that one builds into the analysis, and indeed the assumptions chosen by the underwriter are dubious at best since there is no obvious benchmark comparison for an as yet non-existent security.[128] An issuer could build a financial model with alternate assumptions to support a different price. Doing so, however, might require a greater degree of financial sophistication than many issuers possess. Underwriters may seek to exploit this asymmetry in financial sophistication in pushing the issuer towards a suboptimal price.

A further reason for an issuer to accede to its underwriter's pricing recommendation is the possibility that underpricing has very little adverse impact on the issuer's managers because they view it through the generally positive frame of the IPO as a whole. Managers receive the bad news about underpricing at the same time that they receive the good news about the success of the offering and the jump in value of their own shares.[129] Simply put, at the same time the issuer's managers learn that their company could have raised more money in their offering, they also learn that the offering has made them rich. The impact of this offsetting good news may placate issuers and keep them from objecting to their company's exploitation at the hands of its underwriters: "If

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[128] *See* McCarthy, *supra* note 105, at 52.

[129] *See* Loughran & Ritter, *Money on the Table*, *supra* note 17, at 420. Loughran and Ritter cite the example of Netscape cofounder James Clark.

> At the closing market price on the first day of trading, his shares were worth $544 million, a 350% increase in his pretax wealth in the course of a few weeks. So at the same time that he discovered that he had been diluted more than necessary due to the large amount of money left on the table, he discovered that his wealth had increased by hundreds of millions of dollars.

Id. As a result, Clark is not likely to have been overly upset about the underpricing. However, the situation may well have been reversed, the authors imagine, if the Netscape offering had not been such a tremendous success.

> Now he should be mad: he has been diluted, and there is no offsetting good news. . . . We conjecture that he would be much more upset at the investment bankers for leaving $32.5 million on the table in this scenario than he was when $151 million was actually left on the table, but was accompanied by the good news that his wealth had increased by 350% in a matter of weeks.

Id.

issuers viewed the opportunity cost of underpricing by itself, issuers would be more resistant to severe underpricing. But because it comes as part of a package that includes the good news of an increase in wealth, there is much less resistance."[130] This emphasis on the frame through which the issuer views underpricing draws on the work done by Kahneman and Tversky under the label of "prospect theory."[131]

Although a story of innocent entrepreneurs being duped by evil investment bankers may be intuitively plausible and morally appealing,[132] issuers on the verge of a public offering are probably not so unsophisticated. Companies are not born one day and taken public the next.[133] Along the way, they develop some degree of sophistication or, at least, are guided by sophisticated investors who often become members of the company's board.[134] Even the notoriously poor business models that entered the public market at the height of the Internet bubble had sophisticated guides through the offering process.[135] Thus, even if young entrepreneurs do not understand

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[130] *Id.* at 424.

[131] Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 ECONOMETRICA 263 (1979) (developing "prospect theory" as a qualification of the predictions of expected utility theory for individual decision-making when confronted simultaneously with losses and gains). *See also* CHOICES, VALUES, AND FRAMES (Daniel Kahneman & Amos Tversky eds., 2000) (discussing decision biases arising from a subject's cognitive frame of reference); Hersh M. Shefrin & Meir Statman, *Explaining Investor Preferences for Cash Dividends*, 13 J. FIN. ECON. 253 (1984) (applying prospect theory to investors' dividend preferences).

[132] In movies and popular culture, at least, employment as a corporate executive or financier is a sure indication of villainy. *See generally* Robert H. Bork Jr., Commentary, *Court Movies Don't Mimic Life; Culture: Couldn't the Demands of Lively Entertainment Still Accommodate a More Balanced View of the System?*, L.A. TIMES, Apr. 5, 2002, at B9 (arguing that popular films "demonize the corporate world"); Arthur W. Samansky, *TV Commercials: The SOB in the Gray-Flannel Suit*, WALL ST. J., Nov. 15, 1988, at 22 (stating that "executive-bashing has been a film maker's staple almost from the day the camera was invented" and supplying a "totally unscientific survey of recent TV commercials [that] finds [businesspeople] pictured as arrogant, uncaring and unreasonably intolerant of subordinates").

[133] *See generally* Ronald M. Loeb, *Selected Articles On Going Public and Public Disclosure Company Issues, May 1994, in* ADVANCED SECURITIES LAW WORKSHOP 1995, at 305, 310, 311 (PLI Corporate Law and Practice Course, Handbook Series No. B4-7111, Aug. 1995) (describing the ownership composition of most companies at the time of the initial public offering).

[134] *See id.*

[135] The path taken by bad business models on the way to becoming public companies is the subject of numerous business memoirs. *See, e.g.*, J. DAVID KUO, DOT.BOMB: MY DAYS AND NIGHTS AT AN INTERNET GOLIATH (2001) (chronicling the brief success and stunning failure of on-line retailer Value America); STEPHAN PATERNOT & ANDREW ESSEX, A VERY PUBLIC OFFERING: A REBEL'S STORY OF BUSINESS EXCESS, SUCCESS, AND RECKONING (2001) (describing the rise and fall of theglobe.com, a company started by college students in a campus storage room).

comparative valuation analysis, their backers probably do. And because these financial backers have an interest in protecting the value of their investment, they can be expected to prevent investment bankers from exploiting the entrepreneur's lack of financial sophistication.

In addition, the prospect theory account of issuer cognition probably overstates the impact of managers' paper gains. Being rich on paper may be better than being poor, but it is not as good as being rich in dollars. In order to capitalize on their paper wealth, managers and pre-IPO investors must sell their shares, and this they cannot do for months after the offering since they are typically constrained by lock up agreements.[136] Unless they are betting that they will be able to sell at a similarly inflated price six months down the road – a risky proposition at best since the law of gravity of IPOs suggests that they will fall back to earth before too long[137] – managers should understand that their paper wealth will not soon and may never translate into real dollars. This suggests that the sudden realization of paper riches may be good news, but not great news, and that a rational issuer would discount its value when comparing it to the real dollars, millions of them, foregone in the offering.[138] Finally, empirical studies raise doubts concerning the explanatory force of the basic principal-agent model in the underwriting context,[139] further suggesting

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[136] *See* Ronald M. Loeb & Brian Y. Shin, *Negotiating the Underwriting Agreement*, *in* ADVANCED SECURITIES LAW WORKSHOP 1994, at 189, 195 (PLI Corporate Law and Practice Course, Handbook Series No. B4-7070, Aug. 1994) ("The underwriters will require the selling shareholders to enter into 'stand-by' or 'lock-up' agreements under which the selling shareholders agree not to sell shares (other than those included in the offering) for a specified period, which may range from 90 to 270 days but is usually 180 days.").

[137] *See supra* note 63.

[138] And again, even if entrepreneurs are overconfident or overoptimistic, it is unlikely that their venture capitalist backers – those with the greatest experience in taking firms public – would be among the duped in this psychological reckoning. *See, e.g*, Arnold C. Cooper et al., *Entrepreneurs' Perceived Chances For Success*, 3 J. BUS. VENTURING 97 (1988) (reporting that over 80% of entrepreneurs sampled believed their chances of success were 70% or better and that one third of respondents believed success to be certain).

[139] The central argument against the simple principal-agent model is that if it is to account for underpricing, then there should be no underpricing in situations where there is no principal-agent separation between issuer and underwriter, as in self-underwritten offerings where an investment bank takes *itself* public. However, studies of self-underwritten offerings find, contrary to the implications of principal-agent theory, that underpricing is as common as it is in traditionally underwritten offerings. *See* Chris J. Muscarella & Michael Vetsuypens, *A Simple Test of Baron's Model of IPO Underpricing*, 24 J. FIN. ECON. 125 (1989). Although this evidence provides a strong counter-argument to the principal-agent model of underpricing, it

that issuers are not simply duped by their bankers. There must be something else going on.

C. *Corruption of the Issuer's Management*

If investment bankers cannot simply fool issuer-managers into accepting a suboptimal offering price, perhaps they can bribe them.[140]

Investment bankers in search of a commodity to induce management concessions in the pricing negotiation may have found the perfect item in spinning allocations.[141] By spinning

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ought not to be taken as an absolute refutation of the model. Investment bank issuers may have special reasons to underprice since, as underwriters, they ordinarily seek to persuade others to do so. Therefore, an investment bank's failure to underprice may harm its reputation and credibility with clients. *See* Ritter & Welch, *Review*, *supra* note 118, at 1805 ("underwriters may want to underprice their own offerings in order to make the case that underpricing is a necessary cost of going public"). Also, investment banks are not "monolithic institutions," and there may be intra-firm agency costs favoring underpricing. *See* JENKINSON & LJUNGQVIST, *supra* note 55, at 88. If increased trading commissions and other wealth effects of IPO allocations are distributed to favor the bank's brokerage department, the brokerage department may lobby for underpricing notwithstanding the fact that underpricing will not necessarily benefit the bank as a whole. Managers may cede to these demands in order to keep their brokers happy and productive, especially if underpricing enables the bank to generate other non-transparent proceeds through the creation of goodwill.

[140] Professor Coffee offers the following example:

> Imagine you are the chief financial officer of a Silicon Valley company that has just done a successful initial public offering (IPO). The offering price was $ 20 per share, and the stock ran up to $ 28 on the first day. You are annoyed that this one day run-up of 40 percent implies that underwriters underpriced the stock . . . . When you express your dissatisfaction with the pricing of the offering to the managing underwriter, he replies: "Don't worry. We'll make it up to you." He also makes a vague reference to their opening a discretionary trading account for you.
>
> A week later, you get a phone call from the same underwriter, who tells you: "Congratulations, we allocated you 2,000 shares in the Applied Micro Digital IPO today, and it went up $ 6 on the first day, when we sold you out for a $ 12,000 profit." . . . You are also told that you are getting the same deal that Bradford Jones, the well known venture capitalist who sits on your board, has long had with the underwriter. (You later recall that it was Jones who recommended this underwriter).

John C. Coffee, Jr., *'Spinning' for Dollars: IPOs and Allocation of Hot Issues*, N.Y.L.J., Mar. 26, 1998, at 5.

[141] As developed in this section, spinning can be distinguished from the small gifts, dinners, and nights of entertainment common in business as different in *kind* as well as *degree*. Analyses focusing on spinning as a mere promotional activity treat the difference as one of *degree* rather than *kind*. Spinning is different, the argument goes, because the dollar value is so much greater than the dollar value of greens fees at the country club or a box at Yankee Stadium, and higher dollar value gifts are more likely to influence management's choice. *See, e.g.*, Therese H. Maynard, *Spinning in a Hot IPO – Breach of Fiduciary Duty or Business as Usual?*, 43 WM. & MARY L. REV. 2023, 2037-38 & n.34 (2002) (emphasizing the quantitative distinction and concluding that "[t]he notion that there is – or might be – a difference between paying the greens fee of a CEO/manager who accompanies the investment banker on a golf outing, on the one

underpriced shares of other issuers to their counterparts across the negotiating table, underwriters may hope to induce them to accept underpricing in their own offering.[142] Underpricing, in other words, is not merely a necessary *means* to enable the creation of spinning allocations, it is also a desired *end* of the underwriter's allocation practices. Spinning is not a mere promotional activity. Rather, it is *an element of the bargain* between the issuer and the underwriter.

Spinning is part of a complex wealth transfer between the issuer, the underwriter, and the issuer's managers. Wealth, in the form of underpricing, is transferred first from the issuer to the underwriter. Next, the underwriter transfers most of the value of underpricing, in the form of spinning allocations, to others. This value is later returned to the underwriter in the form of increased brokerage commissions, investment banking business, or other returns on goodwill. Part of the underwriter's spinning activities, however, must be directed towards the issuer's managers or they will not agree to underpricing.[143] A spinning allocation to the issuer's managers thus enables the underwriter to get more of what it wants (underpricing) while the issuer gets less of what it wants (capital). In this way, although the side payment is made by the underwriter in the form of shares of *other* IPOs, *the ultimate source of funds is the issuer itself* since the issuer would raise more capital if spinning did not occur. Wealth travels in a circle from the issuer (as underpricing) to the underwriter (as a goodwill-generating opportunity and insurance against a sticky issue) to the issuer's managers (as spinning, in return for making the pricing concession). The underwriter is merely an intermediary. Managers who accept

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hand, and the underwriter's practice of spinning, on the other hand, seems rather obvious"). This may be a sensible practical distinction, but it is not completely satisfactory. Clearly, even small gifts are intended to exert some influence. If they were not, why would underwriters give them? If it is influence that is the problem, then should we not ban all such gifts in order to prevent them from influencing the issuer's decision?

[142] Linking spinning to underpricing strengthens the prospect theory explanation. *See supra* notes 129-31 and accompanying text. Spun shares can be flipped immediately and are therefore as good as cold, hard American cash. If, as prospect theory asserts, managers and pre-IPO shareholders glom the bad news of underpricing together with the good, spinning should be added to the weight of the good. Spun shares increase the girth of the manager's wallet, not just his or her hypothetical net worth.

[143] *See* Elkind & Gimein, supra note 51 (quoting a fund manager who stated "stock would go into the hands of [the] venture capitalists and the managements of companies that were going to go public next").

spinning allocations participate in a transaction that by nature and design prevents the issuer from maximizing capital raised in the offering.

Empirical support for this theoretical account linking spinning and underpricing is somewhat hard to come by. If the receipt of spun shares exerts a significant influence on an issuer's managers when they agree to underprice their offering, then underpricing should be more common or consistently greater in firms whose managers receive spinning allocations. The ideal test of this implication would compare underpricing in those firms whose managers have received spinning allocations to underpricing in those firms whose managers have not. A strong statistical correlation between the receipt of spinning allocations and the amount or degree of underpricing would provide firm evidence of the connection between spinning and underpricing.

Unfortunately, these data do not exist.[144] There is, however, a second-best, highly unscientific way to perform this test. Although the reliability of the information is suspect, it is possible to construct, from press releases and other publicly available information, a list of issuers whose managers allegedly accepted spinning shares. Table 1 attempts to construct such a list for the period 1999-2000 and includes, for each such issuer, the offering price, closing price on the first day of aftermarket trading, and the resulting margin of underpricing.

[144] Not surprisingly, issuer-managers who have been the recipients of spinning allocations are not eager to confess it. And underwriters, who remain concerned about their reputations and future business, have not been willing to disclose all of the issuer-managers to whom they have spun shares or even to admit that they engaged in spinning at all. The settlement documents of the recent regulatory initiatives probing analyst conflict of interest have not produced a wealth of data on spinning. Although SSB and CSFB were singled out as having engaged in the practice, they were not made to produce a list of all issuer-managers who received spinning allocations. *See* Securities Exchange Commission, *SEC Fact Sheet on Global Analyst Research Settlements*, *at* http://www.sec.gov/news/speech/factsheet.htm (last visited Feb. 1, 2004).

Table 1: Underpricing and Spinning[145]

Issuer	Offering Price ($)	First-Day Closing Price ($)	Underpricing (%)
iVillage	24.00	80.13	233.9
TheStreet.com	19.00	60.00	215.8
Vitria Technology	16.00	48.25	201.6
Portal Software	14.00	37.38	167.0
E-Loan Inc.	14.00	37.00	164.3
EBay	18.00	47.38	163.2
Phone.com	16.00	40.13	150.8
Interwoven Inc.	17.00	41.00	141.2
Razorfish Inc.	16.00	33.50	109.4
El Sitio Inc.	16.00	33.31	108.2
Microtune Inc.	16.00	30.13	88.3

A casual comparison of the underpricing of these firms to the average underpricing of all firms for the relevant period reveals larger average underpricing margins for those firms whose managers are suspected of having taken part in spinning.[146]

Nevertheless, the data in this table should not be used to draw firm conclusions, and caution is urged on several points. First, firms listed as spinning recipients are also included in the overall average of underpricing for the relevant

[145] For information on issuer-managers and investment bankers having allegedly engaged in spinning, see Complaint of NASD, Department of Enforcement v. Frank Peter Quattrone (Mar. 6, 2003) (Disciplinary Proceeding No. CAF030007) [hereinafter *NASD Quattrone Complaint*] (detailing spinning allegations against CSFB), *available at* http://www.news.findlaw.com/hdocs/docs/csfb/nasduatt30603spincmp.pdf; Press Release, House Committee on Financial Services, Oxley Calls for Reform: IPO Investigation Shows Preferred Investors Profited Unfairly, Data Sheet Attachment (Oct. 2, 2002) (detailing spinning allegations against CSFB and Goldman Sachs), *available at* http://financialservices.house.gov/news; Charles Gasparino & Randall Smith, *Quattrone Faces Civil Charges on "Spinning,"* WALL ST. J., Mar. 7, 2003, at C1; Matt Krantz & Noelle Knox, *Some Execs Dispute Claim Of IPO Access; House Panel Says Shares Used To Woo Business*, USA TODAY, Oct. 3, 2002, at B3; Randall Smith, *Goldman Gave Hot IPO Shares To Top Executives of Its Clients*, WALL ST. J., Oct. 3, 2002, at A1; Randall Smith et al., *Something Ventured and Something Gained? It Wasn't Just Top Executives Who Received Hot IPO Shares: Venture Capitalists Did, Too*, WALL ST. J., Oct. 17, 2002, at C1; Smith & Pulliam, *supra* note 51. Information on offering price and first day closing prices assembled from Ritter, *IPO Runups*, *supra* note 121.

[146] Underpricing averaged 71.7% in 1999 and 56.1% in 2000. *See* Ritter, *Factoids*, *supra* note 119, at 4 tbl.3.

period. Second, a list drawn from sporadic press accounts is likely to be highly underinclusive with regard to actual spinning activity, and as a result, many firms in the sample used to generate average underpricing will be firms that have also received spinning allocations. Thus, although the data in the table permit a casual comparison of spinning recipients to average issuers, it is not possible to use these data to compare the underpricing margins of firms engaging in underpricing to those that do not.[147]

In light of the poverty of direct comparative data, confirmatory evidence must be sought in indirect empirical studies. Proceeding in this fashion, Professors Loughran and Ritter have argued that the link between spinning and underpricing, which they refer to as the "corruption hypothesis," is supported by three factors observed during the severe underpricing of the late 1990s.[148] First, underpricing margins expanded considerably during the IPO boom of the late 1990s.[149] Second, there was also increased shareholder turnover – or "flipping" – in the secondary market during this time.[150] Third, contrary to the usual conception of underwriter

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[147] It is worth noting, however, that these weaknesses of the data set make the argument for a link between spinning and underpricing stronger, not weaker. That is, even though the ratio of firms receiving spinning allocations to firms not receiving spinning allocations probably includes at least some firms receiving spinning allocations in the denominator, the result of the comparison still shows greater underpricing for firms suspected of having received spinning allocations over a broad set of those that may or may not have.

[148] *See* Loughran & Ritter, *Underpricing Over Time, supra* note 18, at 5 ("The corruption hypothesis asserts that decision-makers are willing to hire underwriters with a history of underpricing due to the side payments that the decision-makers receive.").

[149] Data from 1980 through 1994 suggest that IPO underpricing, while common, was typically quite narrow, within the range that might have been predicted by hypotheses focusing on the need to reward investors for disclosure. Average underpricing from 1980-1989 was 7.4%, with median underpricing at 1.9%, but rose from 1990-1998 to 14.8%, with a median of 7.8%. *See id.* at 41-42 tbl.1 & tbl.2. Moreover, in 1999 and 2000, average underpricing shot to 65%, with a median of 32.3%. *Id.* at 40-41. The average underpricing of each year from 1995 through 2000 was higher than any one year from 1981 through 1994. *Id.* at 13. Meanwhile, total dollars left on the table jumped to an average of $79 million per offering, up from $9.3 million in 1990-1998 and $2.6 million in 1980-1989. *See id.* at 40 tbl.1. All of this data supports a radical increase in underpricing in the late 1990s.

[150] In the 1980s only 1.6% of IPOs had greater than 100% turnover. From 1990 through 1998, this percentage climbed to 23.6%, and by 1999-2000, 74.7% of IPOs had a turnover rate greater than 100%. Turnover increased as average first day returns, or underpricing, increased. Offerings that returned between 10% and 60% had average turnover of 84.7% across the sample periods, but 137.9% turnover in 1999-2000, and offerings returning more than 60% in first day trading experienced 177.6% turnover across periods, but 200.9% turnover in 1999-2000. *See id.* at 45 tbl.5. (defining turnover as "first-day CRSP trading volume divided by the number of shares issued").

reputation,[151] prestigious underwriters increasingly engaged in underpricing.[152]

These three factors taken together, Loughran and Ritter argue, support the corruption hypothesis. The correlated increase in both underpricing and shareholder turnover suggests that the privileged recipients of hot IPO allocations seek to sell quickly, while the shares are still hot. At the same time, the increase in underpricing by prestigious investment banks suggests that issuers not only accepted significant underpricing margins but also sought them out. According to Loughran and Ritter, the allocation of hot IPO shares to the personal brokerage accounts of venture capitalists and managers of the issuer "gives these decision-makers an incentive to choose a lead underwriter with a reputation for leaving money on the table in IPOs."[153] The practice increased as the number of hot IPOs in the market increased and as other management teams sought to enrich themselves with spinning allocations.[154] In other words, the practice increased as

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[151] The generally held view is that underwriters harm their reputations by underpricing their offerings. *See, e.g.*, McCarthy, *supra* note 105, at 56 ("Underpricing costs the company substantial sums and can damage the investment banker's reputation."); *accord* Baron & Holmstrom, *supra* note 124, at 1117 ("a banker that continually prices new issues 'lower' than the industry norm is likely to lose some market share").

[152] In the 1980s, the average underpricing of offerings by high prestige underwriters, at 5.1%, was almost half that of low prestige underwriters, at 9.1%. From 1990-1998, the relationship had already reversed itself, with high prestige underwriters underpricing at an average of 15.9% and low prestige underwriters underpricing at 12.9%. As with underpricing and flipping, in 1999-2000, the relationship of underwriter prestige and underpricing became extreme. High prestige underwriters offered shares underpriced by an average of 71.9%, while low prestige underwriters underpriced by half as much, 35.1%. Median underpricing by high prestige underwriters in 1999-2000 was 37.5% while it was 12.2% for low prestige underwriters. By the end of 2000, underwriters no longer seemed to fear damage to their reputation from engaging in extreme underpricing. *See* Loughran & Ritter, *Underpricing Over Time*, *supra* note 18, at 47 tbl.7; *accord* Randolph P. Beatty & Ivo Welch, *Issuer Expenses and Legal Liability in Initial Public Offerings*, 39 J.L. & ECON. 545, 584 (1996) ("We find that higher-quality underwriters underpriced more, especially among smaller firms.") (emphasis omitted). The categories "high prestige" and "low prestige" are based on scores earned on the scale developed by Carter and Manaster. *See* Richard B. Carter & Steven Manaster, *Initial Public Offerings and Underwriter Reputation*, 45 J. FIN. 1045 (1990) (developing a nine point scale to measure underwriter prestige). The prestige of underwriters can also be gleaned by their place in a typical "tombstone" advertisement. *See id.* at 1055. *See generally* Richard B. Carter et al., *Underwriter Reputation, Initial Returns, and the Long-Run Performance of IPO Stocks*, 53 J. FIN. 285 (1998).

[153] Loughran & Ritter, *Underpricing Over Time*, *supra* note 18, at 30.

[154] As more hot IPOs became available, the exchange value of the IPO allocation increased:

more issuer-managers demanded free money, which bred an environment where more issuer-managers were willing create it by underpricing their own issue.

Further empirical support for a version of the corruption hypothesis is offered by Professors Ljungqvist and Wilhelm, who demonstrate an inverse relationship between underpricing and insider ownership.[155] In their words:

> Standard principal-agent theories predict that agents will expend less effort in bargaining and monitoring on behalf of their principals when the agents' stake in the transaction is smaller. ... [Consistent with this prediction,] underpricing is significantly lower when insider ownership stakes are larger and less fragmented and when insiders sell more shares at the offer price.[156]

Decreased insider ownership suggests decreased manager incentives to monitor the pricing process. Spinning represents a further disincentive for managers to police the efficient pricing of the firm's IPO.

This mix of direct and indirect empirical data supports the link between spinning and underpricing that this Article has sought to establish. Asserting this link requires neither strong position (1) that spinning is a complete explanation for underpricing nor (2) that underpricing is the only reason underwriters engage in spinning. As noted above, there are various explanations for underpricing, and spinning is consistent with many of them.[157] Moreover, as also noted, there may be any number of possible quid pro quo arrangements used by underwriters to generate goodwill through spinning.[158] Underwriters may spin shares to please their brokerage clients or, even, to tip their doormen and mail carriers at Christmas. This Article claims only that *one* important constituency for spun shares is the management of issuers that the underwriters will take or have taken public, and that *one* of the

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> In the 1980s, relatively little money was left on the table in IPOs because valuations were low . . . . When there were few hot IPOs to hand out, IPOs were not a good currency to use to influence decision-makers. As IPO underpricing increased in the 1990s, however, the ability to use hot IPOs to reward decision-makers resulted in the decision-makers seeking out underwriters with reputations for leaving money on the table, rather than avoiding these underwriters.

Id. at 30.

[155] *See* Ljungqvist & Wilhelm, *supra* note 18.

[156] *Id.* at 2.

[157] *See supra* Part III.A-E.

[158] *See supra* Part II.A.

reasons for these allocations is to appease managers whose own offerings have been or will be underpriced.

IV. INVESTOR HARM

This Article has thus far considered spinning as a benefit to underwriters and, through its link to underpricing, as a cost to issuers. It will now turn to the question of how spinning and underpricing affect investors.

This Part examines three possible investor complaints concerning the practice of spinning. First, investors may complain that spinning harms them by making it harder, or more expensive, to become shareholders of the issuer. Second, because spinning allocations are made primarily to corporate managers,[159] shareholders of that company may claim that the benefit of the manager's spinning allocation properly belongs to the corporation, to be shared by all of its shareholders, rather than to the individual manager alone. Third and finally, investors may be harmed if managers breach their duties to the corporation as a result of the conflict of interest created by their receipt of spinning allocations.

A. Fairness and Investment Allocations

One of the most common complaints about the IPO allocation process in the hot issue market of the 1990s was that underwriters routinely passed over individual investors, instead allocating hot offerings to institutional investors and preferred retail clients.[160] Revelations about the practice of spinning, because it involves the favoritism of certain wealthy and well-connected individuals over public investors generally, added fuel to these fires.[161] Public outrage at spinning may thus reduce to the simple fact that ordinary public investors do not

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[159] *See* Siconolfi, *supra* note 10.

[160] *See, e.g*, Evan I. Schwartz, *The Great IPO Swindle*, INDUSTRY STANDARD, Mar. 20, 2000 (lamenting the individual investor's inability to receive hot IPO allocations and estimating the odds of receiving such an allocation at 1000 to 1). *See also The Osgood File: WorldCom's Bernie Ebbers and Four Other Chief Execs Charged for Spinning IPOs* (CBS News Radio Broadcast, Oct. 1, 2002) ("The P in IPO stands for public. But sometimes by the time the public is aware of an initial public offering, it's already subscribed to, allocated to somebody else. Sometimes it's because of what Wall Street calls spinning. A form of, 'You scratch my back and I'll scratch yours,' under which executives of corporation[s] that bring investment bank[s] a lot of business are personally rewarded."), *available at* 2002 WL 4625546.

[161] *See generally supra* note 13 (expressing public contempt for the practice).

benefit from it. Preferential allocation is, in other words, further evidence that the capital-raising process is indifferent to the interests of the individual investor. This sentiment is amply reflected in the statements of those politicians and regulators who have campaigned as champions of the individual investor.[162]

It is nevertheless unclear that the individual investor *should* have a greater role in public offerings. The shape of IPO allocations may be the result of an efficient capital-raising process. Individual investors have a relatively small role because they are less important to the process than institutional investors. Institutions are more attractive buyers because they are willing and able to buy large blocks of shares, reducing marketing costs and spreading underwriter risk.

Institutions are also far more likely than individuals to be repeat players in the IPO market.[163] Because both the underwriter and the institution know that they will need each other in the future, they are more likely to accommodate one another in the present. If, for example, the underwriter needs to sell a cold offering – one expected to spark little aftermarket demand – the underwriter may be able to call on its institutional clients to take an allocation, implicitly promising them shares of hot IPOs in the future. By enabling underwriters to spread the risk of sticky issues, this relationship should render them less reluctant to bring risky issues to market, thereby reducing the cost of capital to issuers. Furthermore, as noted above, allocations to institutions reduce marketing costs, reduce the underwriter's risk, and solve the problem of investors' strategic withholding of information.[164]

In other words, it may be neither coincidence nor conspiracy that over seventy percent of IPO shares are sold to

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[162] *See supra* note 15.

[163] Institutions have a steady supply of money to invest. Moreover, fund managers actively manage their investments in search of optimal returns, underwriters can be confident that institutional investors will be willing at least to consider each new investment opportunity. Individuals, by contrast, are more likely to invest sporadically and cannot therefore be counted on as a ready source of capital. Repeat play has important implications for the development of cooperation. *See generally* ROBERT AXELROD, THE EVOLUTION OF COOPERATION 96 (1984) (describing the strategy of tit-for-tat in a multi-round game); John O. Ledyard, *Public Goods: A Survey of Experimental Research,* in THE HANDBOOK OF EXPERIMENTAL ECONOMICS 111, 142 tbl.2.9 (John H. Kagel & Alvin E. Roth eds., 1995) (summarizing the evolution of cooperation in studies of multi-round games).

[164] *See supra* Part III.A.4 (discussing the investor reward hypothesis).

institutions.[165] It may instead be the result of an efficient capital-raising process. A regulatory response that mandated an increased role for individuals over institutions would thus threaten to reduce the efficiency of the capital-raising process and thereby increase the cost of capital to issuers.

B. Corporate Opportunities

From the point of view of the issuer and its investors, a second problem relating to spinning concerns the question of who should benefit from a profitable IPO allocation. The profit opportunity of an IPO allocation might, under certain circumstances, be thought properly to belong to the corporation, to be shared by all of its shareholders, rather than to the individual managers who received the allocation from the underwriter. This application of the corporate opportunity doctrine to the practice of spinning, first articulated by Professor Maynard,[166] has recently been endorsed by the Delaware Court of Chancery.[167]

The fundamental principle underlying the corporate opportunity doctrine is that a director or officer, in her role either as a fiduciary or an agent of the firm, ought not to take for herself a business prospect or profit opportunity that should go to the corporation.[168] Of course, deciding what opportunities should go to the corporation poses difficulties, and courts have created an assortment of factor-based tests to answer the

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[165] *See supra* note 9. *See also* Phillip L. Zweig et al., *Beware the IPO Market: Individual Investors are at a Big Disadvantage*, BUS. WK., Apr. 4, 1994, at 84 (reporting on studies finding that institutional investors receive the majority of allocations of hot IPOs).

[166] Maynard, *supra* note 141.

[167] *See In re* eBay Shareholders Litigation, C.A. No. 19988-NC, 2004 Del. Ch. LEXIS 4, *11 (Del. Ch., Jan. 23, 2004) (refusing motion to dismiss plaintiff's derivative claims relating to spinning and holding that "[p]laintiffs have stated a claim that defendants usurped a corporate opportunity of eBay").

[168] *See generally* Kenneth B. Davis, Jr., *Corporate Opportunity and Comparative Advantage*, 84 IOWA L. REV. 211 (1998) (favoring approach granting corporate opportunities to directors and officers early in a firm's development); Harvey Gelb, *The Corporate Opportunity Doctrine – Recent Cases and the Elusive Goal of Clarity*, 31 U. RICH. L. REV. 371 (1997) (attempting to place recent cases within the existing doctrinal paradigm); Eric Talley, *Turning Servile Opportunities To Gold: A Strategic Analysis Of The Corporate Opportunities Doctrine*, 108 YALE. L.J. 277 (1998) (arguing that the corporate opportunities doctrine operates as a default mechanism for allocating property rights between a corporation and those who manage it and that the doctrine implements the terms of a contract that the parties would have reached through Coasean bargaining).

question, focusing on such items as the firm's line of business,[169] the interests and expectancies of the corporation,[170] and the capacity in which the individual became aware of the prospect.[171] The basic concerns motivating these tests can be traced at least to the *Meinhard v. Salmon* opinion,[172] in which Judge Cardozo remarked famously, perhaps infamously, that:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior.[173]

In spite of the proliferation of standards, or perhaps because of it,[174] determining what constitutes a corporate opportunity is

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[169] Guth v. Loft, Inc., 5 A.2d 503 (Del. 1939).

> [I]f there is presented to a corporate officer or director a business opportunity which the corporation is financially able to undertake, is from its nature, in the line of the corporation's business and is of practical advantage to it, is one in which the corporation has an interest or reasonable expectancy, and, by embracing the opportunity, the self-interest of the officer or director will be brought into conflict with that of his corporation, the law will not permit him to seize the opportunity for himself. And, if, in such circumstances, the interests of the corporation are betrayed, the corporation may elect to claim all of the benefits of the transaction for itself, and the law will impress a trust in favor of the corporation upon the property, interests and profits so acquired.

Id. at 511.

[170] The prior interest or expectancy test asks whether the opportunity is something that the corporation would have wanted (an interest) or whether it is something that in the ordinary course of business would have come to the corporation (an expectancy). *See* Gauger v. Hintz ,55 N.W.2d 426 (Wis. 1952).

> [O]ne who occupies a fiduciary relationship to a corporation may not acquire, in opposition to the corporation, property in which the corporation has an interest or tangible expectancy or which is essential to its existence. This corporate right or expectancy . . . may arise from various circumstances; such as, for example, the fact that directors had undertaken to negotiate in the field on behalf of the corporation, or that the corporation was in need of the particular business opportunity to the knowledge of the directors, or that the business opportunity was seized and developed at the expense, and with the facilities of the corporation.

Id. at 435-36.

[171] *See Guth*, 5 A.2d at 510 (noting that, in addition to other considerations, if "a business opportunity comes to a corporate officer or director in his individual capacity rather than in his official capacity . . . the officer or director is entitled to treat the opportunity as his own").

[172] 249 N.Y. 458, 164 N.E. 545 (1928). The issues in *Meinhard* arose in the context of a joint venture, but the basic principle – that a co-venturer may not take for himself an opportunity that ought to go to the enterprise – can be seen to motivate the corporate opportunity doctrine.

[173] 249 N.Y. at 464, 164 N.E. at 546.

[174] Each of the various factors for determining a corporate opportunity has been critiqued. *See, e.g.*, Victor Brudney & Robert Charles Clark, *A New Look at*

not much easier, or much more principled, than engaging in punctilio analytics.[175]

Professor Maynard's application of the corporate opportunity doctrine to the practice of spinning traces the example of Robertson Stephens' allocation of Pixar IPO shares to Joseph Cayre, the CEO of GT Interactive Software, a firm then planning its own public offering.[176] Professor Maynard focuses on the capacity factor, emphasizing that since Cayre's

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Corporate Opportunities, 94 HARV. L. REV. 997, 1012 (1981) ("The case law conception of 'line of business,' which is analogous to functional relationship, is ephemeral, being sometimes as broad as the corporate charter and other times limited by the firm's actual operations."); *id.* at 1014-16 (noting that "the cases have reached contradictory conclusions regarding the existence of an interest in contexts that are not relevantly distinguishable" and concluding that "the concept is of little help in deciding particular cases or predicting the outcomes of the next ones") (footnotes omitted). Brudney and Clark further criticize the line of business test on the basis of economic theory, according to which "the modern publicly held corporation should accept any opportunity that it expects will produce a risk-adjusted rate of return at least matching that of its current operations," leaving the corporation's "line of business" potentially open to any opportunity regardless of its type and relationship to the firm's current operations. *Id.* at 1025 (footnote omitted). As a result of this individual indeterminacy, courts occasionally mix factors and pick and choose among the various available tests. *See, e.g.*, Alexander & Alexander of New York, Inc. v. Fritzen, 542 N.Y.S.2d 530, 534-35,147 A.D.2d 241, 248 (N.Y. App. Div. 1st Dept. 1989) (reciting the various tests and noting that "none of these tests alone is consistently sufficient to answer the question of what constitutes a 'corporate opportunity'. While the cases in this jurisdiction have generally announced reliance on the 'interest or tangible expectancy' test, in some instances consideration has been given to the other tests. Some cases refer to all relevant factors.") (citations omitted). *See also* Pat K. Chew, *Competing Interests In The Corporate Opportunity Doctrine*, 67 N.C. L. REV. 435, 466-67 (1989) ("[V]arious jurisdictions appear to have incongruent and unpredictable approaches to corporate opportunity disputes. Even within the same jurisdictions, the courts sometimes cite different tests. Even when the courts cite the same test, they interpret them differently.") (footnotes omitted).

[175] Delaware recently revisited its approach to corporate opportunities in *Broz v. Cellular Information Systems, Inc.*, 673 A.2d 148 (Del. 1996). There, the court emphasized the following factors:

> [whether] (1) the corporation is financially able to exploit the opportunity; (2) the opportunity is within the corporation's line of business; (3) the corporation has an interest or expectancy in the opportunity; and (4) by taking the opportunity for his own, the corporate fiduciary will thereby be placed in a position inimicable [sic] to his duties to the corporation.

Id. at 155. The Court in *Broz* also noted that notwithstanding the existence of a corporate opportunity, the director or officer could nevertheless seize the prospect for herself if:

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

Id.

[176] *See* Maynard, *supra* note 141. This is the same example that the *Wall Street Journal* used in breaking the story in its 1997 exposé of spinning. *See supra* note 10.

receipt of spinning allocations was a direct result of his position within GT Interactive, his fiduciary duties required him to offer the opportunity to the corporation.[177] On the basis of this analysis, Professor Maynard ultimately concludes that there is "no doubt that the common law, including Delaware, would find that this investment opportunity constituted a corporate opportunity."[178]

Given the vagaries of factor-based analyses, however, this conclusion is far from certain. Indeed, other factors of corporate opportunity analysis are more ambiguous in their treatment of the practice, and some weigh against the finding of a corporate opportunity. Because "[n]o one factor is dispositive and all factors must be taken into account insofar as they are applicable,"[179] these considerations may prevent courts from finding a usurpation of corporate opportunity in the practice of spinning. First, although the corporation might be able to afford to undertake the investment opportunity, an operating company, such as GT Interactive, is probably not in the line of business of investing in the IPO market. Similarly, because operating companies, unlike holding companies and investment funds,[180] ordinarily earn returns through their

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[177] *See* Maynard, *supra* note 141, at 2080-81.

> Because the opportunity came to Mr. Cayre only because of his position within the corporation and in apparent anticipation that he would direct the corporation's investment banking business to Robertson Stephens, it would seem the corporation's interest predominates the individual interests of the corporation's CEO, Mr. Cayre. Accordingly, if this allocation was made in order to obtain the company's future business, it would seem that this investment opportunity should be shared with *all* shareholders of GT Interactive.

Id. (emphasis in original).

[178] Maynard, *supra* note 141, at 2081.

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

[180] Unlike operating companies, investment companies and other entities primarily engaged in investment easily meet the line of business and interest/expectation prongs of corporate opportunities analysis for their spinning gains. Moreover, several such companies appear to have participated in spinning during the late 1990s. *See* Smith et al., *supra* note 145 ("Recent disclosures . . . about the allocation of hot IPOs generally have focused on chief executives or their chief financial officers . . . . But also receiving generous allotments of IPO shares were venture capitalists, whose firms invest in early stage companies and who often help determine which investment banks fledgling companies select when they decide to go public themselves."). In addition to the usurpation of a corporate opportunity, fund managers who take spinning allocations for themselves rather than for their fund also violate the NASD's Free-Riding and Withholding Rules. *See* National Association of Securities Dealers, Inc., NASD Manual Conduct Rules, Rule IM-2110-1(b)(4) (2003) (barring the allocation of hot issues to officers who may determine the investment decisions of any "institutional type account," including "a bank, savings and loan institution, insurance company, investment company, [and] investment advisory firm"). *See also supra* notes

operations rather than their investments, it is difficult to argue that the corporation has an interest in or expectation of receiving the spinning allocation. Considering all of the factors relevant to a corporate opportunity analysis, at least in Delaware, introduces considerable doubt into whether spinning would be treated as a corporate opportunity that could not be taken by the manager.[181]

The lack of clarity surrounding the corporate opportunity doctrine, however, should not obscure spinning as a potential fiduciary duty problem. Corporate opportunity analysis is not a separate doctrine, but rather a subcategory of duty of loyalty analysis.[182] If corporate opportunity analysis is not particularly apt, general duty of loyalty principles may still apply to the practice.

C. *Corruption and Conflict of Interest*

This Article has sought to emphasize that the practice of spinning is inextricably intertwined with the underpricing of IPOs.[183] Spinning from an underwriter to an issuer's managers may amount to a quid pro quo arrangement, according to which the managers accept the benefit of the allocation in exchange for the underpricing of their company's offering.[184] Because it effectively enriches the issuer's managers at the expense of the company they manage, this tacit arrangement may violate the managers' duty of loyalty to the issuer.

36-39 and accompanying text (discussing Free-Riding and Withholding Rules in connection with spinning).

[181] Delaware's permissive approach to corporate opportunities bears special emphasis in light of the recent amendment of the General Corporation Law to permit corporations to opt-out of the corporate opportunities doctrine through a charter provision. *See* DEL. CODE ANN. tit. 8 § 122(17) (2003). Added in 2000, this provision adds to the enumerated power of Delaware corporations the power to:

> [r]enounce, in its certificate of incorporation or by action of its board of directors, any interest or expectancy of the corporation in, or in being offered an opportunity to participate in, specified business opportunities or specified classes or categories of business opportunities that are presented to the corporation or 1 or more of its officers, directors or stockholders.

Id. Other states, especially those adopting the ALI approach, may still follow a restrictive approach to corporate opportunities. The ALI test for corporate opportunities is written in the disjunctive, so the failure of spinning allocations to meet the capacity standard – for the reasons advanced by Professor Maynard – would be an adequate basis to find a corporate opportunity in a state following the ALI model. *See* ALI, Principles of Corporate Governance, § 5.05(b).

[182] *See* Gelb, *supra* note 168.

[183] *See supra* Parts II and III.

[184] *See supra* Part III.C.

As a general matter, analyses under the duty of loyalty are triggered by the appearance of a conflict of interest between a corporation and its managers.[185] Such conflicts arise when managers stand on both sides of a transaction, acting on one side of the deal in their individual capacity as the seller or lender, and representing the corporation on the other as buyer or borrower.[186] Slightly more subtle conflicts may arise when managers take an interest, such as a commission, in the completion of a particular transaction with a particular party.[187] A conflict of interest alone does not imply a breach of the duty of loyalty, as is emphasized in the Model Business Corporations Act:

> [I]t is important to keep firmly in mind that it is a contingent risk we are dealing with – that an interest conflict is not in itself a crime or a tort or necessarily injurious to others. Contrary to much popular usage, having a "conflict of interest" is not something one is "guilty of"; it is simply a state of affairs.[188]

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[185] *See generally* Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595 (1997).

> The obligation of loyalty is to serve the interests of the beneficiary rather than those of the fiduciary. In its most demanding form, it requires the fiduciary to serve *solely* the beneficiary's interests and to refrain from any kind of behavior (in performing services or in dealing with the beneficiary or the property in its control) from which the fiduciary may gain in excess of specified compensation – even if such behavior imposes no cost on the beneficiaries or, indeed, if the failure to engage in such behavior causes a loss to them.

Id. at 599 n.9. In addition to the duty of loyalty analysis focusing on corporate fiduciaries developed in this section, general agency principles may apply to spinning allocations received by corporate officers. Agents owe their principals a duty of loyalty, which generally forbids agents from receiving other compensation in connection with the agency relationship unless the principal consents. *See* RESTATEMENT (SECOND) OF AGENCY § 388 (1958) ("Unless otherwise agreed, an agent who makes a profit in connection with transactions conducted by him on behalf of the principal is under a duty to give such profit to the principal."). Spinning allocations to corporate officers represent additional compensation coming to the agent by reason of her agency, thus violating basic principles of agency law.

[186] *See, e.g.*, MODEL BUS. CORP. ACT. § 8.60 (1999).

[187] For example, a director or officer may have a financial stake in the transaction through an ownership interest in the counterparty or a commision-based interest in the transaction itself. Alternately, the officer or director may have a seat on the board of the counterparty. In such cases, the conflict of interest is less direct, but nevertheless gives rise to a set of competing duties and interests on the part of the manager. Most state statutes respond to both kinds of conflict. *See, e.g.*, DEL. CODE ANN. tit. 8, § 144(a) (2003) (covering transactions between the corporation and an officer or director as well as transactions in which directors and officers have management positions with the counterparty or "have a financial interest"); CAL CORP. CODE § 3109(a)-(b) (2003) (same).

[188] MODEL BUS. CORP. ACT ANNOTATED § 8.60, subch. F, introductory cmt. (1998).

A conflict of interest, however, does trigger heightened scrutiny under the duty of loyalty, resulting in an insistence on the objective fairness of the transaction.[189] To apply this rubric to the practice of spinning, the threshold question thus is whether the acceptance of a spinning allocation creates a conflict of interest between the issuer and its managers.

If spinning does create a conflict of interest between the issuer and its managers, it is not immediately apparent. After all, the shares given to the issuer's managers are shares from *other* offerings. That those offerings are underpriced would seem to have no bearing on the issuer. The issuer's managers got a good deal, but that does not necessarily imply that the issuer got a bad one. The bad deal, if indeed there is one, seems to be suffered by those *other* issuers whose shares were underpriced and spun to the managers of *this* issuer. But such an account ignores the implicit bargaining between the underwriter and the issuer's managers and the mechanisms of the offering process as a whole.

Although the source of value to managers lies in the underpriced shares of *another* corporation, the intended effect of this payment is to induce management to accede to the underpricing of its *own* public offering.[190] Because they can anticipate resistance in their attempt to underprice the offering, underwriters offer spinning allocations to induce the issuer's managers to concede on price. The wealth transfer is thus *from* the issuer (in the form of foregone offering proceeds) *to* the underwriter (in the form of underpriced shares that both reduce underwriting risk and permit future spinning allocations to other parties) then *partially back* to the issuer's managers (in the form of spinning allocations from other offerings).[191] In light of this process, spinning begins to appear as a non-pro-rata wealth transfer – that is, classic self-dealing.[192]

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[189] *See, e.g.*, Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) ("When directors of a Delaware corporation are on both sides of a transaction, they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.").

[190] *See supra* Part III.C.

[191] The spinning allocation received by the issuer's managers only partially reflects the capital foregone by the issuer through underpricing since a substantial portion of the issuer's aggregate underpricing will be used to generate other spinning and underpricing opportunities for the underwriter.

[192] *See* Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (1971) (defining self-dealing as the receipt of a benefit "to the exclusion of, and detriment to, [the] stockholders").

Transactions involving a conflict of interest between managers and their corporations may survive judicial scrutiny, even without approval or ratification, if the conflicted manager can show that the transaction is "fair" to the corporation and its shareholders.[193] A fair transaction is one that approximates the agreement that unrelated parties would have reached had they bargained at arms length.[194] The fairness test, sometimes stated as "entire fairness" or "intrinsic fairness," thus requires the court to step back and imagine a hypothetical bargain between non-conflicted parties. In the context of spinning, it requires the decision maker to imagine whether the shareholders of the issuer – the real counterparty in the spinning quid pro quo – would agree to the underpricing of the offering and the concomitant allocation of spun shares to management.

Such an agreement is hard to imagine. Although the explanations of underpricing in Part III.A suggested that underpricing could, in some circumstances, benefit the issuer,[195] the only explanation to connect underpricing to spinning rests fundamentally on the problem of agency costs,[196] which by definition cannot benefit the corporation or its shareholders. In other words, it may be that underpricing, in limited amounts and in limited circumstances, is beneficial to the issuer, but it

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[193] *See, e.g.*, Lewis v. S.L. & E., Inc., 629 F.2d 764, 768 (2d Cir. 1980) ("Because the directors of SLE were also officers, directors and/or shareholders of LGT, the burden was on the defendant directors to demonstrate that the transactions between SLE and LGT were fair and reasonable."). *See also* Weinberger v. UOP, Inc., 457 A.2d 701 (Del. 1983) (discussing the fairness standard at length). In addition to allocating the burden of proof to managers in the first instance, courts tend to resolve doubts in the favor of the corporation or its shareholders and *against* conflicted management. *See, e.g.*, Charles Yablon, *On the Allocation of Burdens of Proof in Corporate Law: An Essay on Fairness and Fuzzy Sets*, 13 CARDOZO L. REV. 497 (1991) (explaining tendency of courts to resolve doubts against directors in conflict of interest context by reference to "fuzzy set" theory).

[194] *See, e.g.*, Flieger v. Lawrence, 361 A.2d 218, 225 (Del. 1976) (concluding that an interested director transaction nevertheless passed the test of intrinsic fairness because "this transaction was one which at that time would have commended itself to an independent corporation in [the same] position").

[195] The signaling explanation, for example, suggests that underpricing may benefit the issuer by signaling to other market participants that the issuer is a high value firm. *See supra* Part III.A.1. The lawsuit avoidance explanation argues that underpricing benefits the issuer by reducing the likelihood and cost of securities lawsuits. *See supra* Part III.A.2. The adverse selection hypothesis claims that underpricing benefits issuers by keeping uninformed investors in the market as potential investors in their offerings. *See supra* Part III.A.3. Finally, the investor reward hypothesis argues that underpricing benefits issuers by providing an incentive for investors to reveal the true level of demand. *See supra* Part III.A.4.

[196] *See supra* Part III.C.

does not follow that the outsized underpricing observed in the late 1990s and resulting from the tacit quid pro quo between underwriters and managers benefited the corporation in any way. Moreover, the suggestion that shareholders might agree to some level of underpricing in the offering does not imply that they would allow their managers to receive spinning allocations in connection with the offering. Indeed, why would any shareholder of the issuer allow a private arrangement between its managers and its underwriter that reduced the amount of capital raised in the offering?[197]

Two lines of decisions – one involving secret commissions and compensation arrangements, and the other involving self-interested allocations of costs and benefits – may provide useful analogies to guide the analysis of spinning as a possible breach of the duty of loyalty.

Undisclosed compensation arrangements and secret commissions have been held to create conflicts violating a fiduciary's duty of loyalty. In *Tarnowski v. Restop*,[198] the Supreme Court of Minnesota held that secret commissions paid to a buyer's agent upon consummation of a transaction can amount to a conflict of interest in violation of the agent's duty of loyalty, and condemned the arrangement as "nothing more or less than the acceptance by the agent of a bribe to perform his duties in the manner desired by the person who gave the bribe."[199] Similarly, Delaware courts have held that a target director's finder's fee in connection with a merger transaction can amount to a conflict of interest.[200] A manager's receipt of a

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[197] One response to this question is that spinning is a kind of implicit compensation for managers. However, shareholders presumably favor transparent compensation arrangements as a policy matter so that they know exactly how much they are paying their managers. *See, e.g.*, Regulation S-K, Item 402, Securities Exchange Act of 1934, 17 C.F.R. § 229.402 (2002) (making preference for transparency regarding executive compensation into a securities law obligation). Insofar as spinning represents implicit compensation for participating managers, it is a form of hidden compensation contrary to shareholder preferences and in breach of the manager's duty of loyalty according to the line of cases cited at *infra* notes 198-202 and discussed in the accompanying text.

[198] 51 N.W.2d 801 (Minn. 1952).

[199] *Id.* at 803 (quoting Lum v.Clark, 57 N.W. 662, 663 (Minn. 1894)).

[200] *See* Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1134 (Del. Ch. 1994), *aff'd*, Cinerama, Inc. v. Technicolor, Inc., 663 A.2d 1156 (Del. 1995) (finding, on remand, that the conflict of interest presented by the director's finder's fee was not sufficiently large to support the finding of materiality necessary to conclude that the director had breached the duty of loyalty). Much of the reasoning in the *Technicolor* case can be limited to the context of a merger transaction. Mergers involve large scale changes in the business of a corporation, often resulting in a reshuffling of management. If the court had shown itself to be too liberal in finding material conflicts

spinning allocation is like an agent's receipt of a secret commission because it gives the manager an incentive to favor the counterparty over her principal – in this case, to favor the underwriter in a pricing negotiation over the issuer. This conflict of interest, given the magnitude of foregone offering proceeds and the value of the spinning allocation to the recipient,[201] ought easily to be found sufficiently material to constitute a breach of the duty of loyalty.[202] It resembles, as some commentators have noted, "commercial bribery."[203]

Spinning also evokes a line of cases finding a breach of the duty of loyalty when managers allocate the risk or cost of a transaction to their corporation but keep the benefits for themselves. In *Enstar Group, Inc. v. Grassgreen*,[204] defendants who were corporate managers as well as partners in a private investment fund were held to have breached their duty of loyalty to the corporation in connection with a scheme that allocated costs, in the form of investment obligations, to the corporation, but allocated benefits, in the form of "commitment fees," to their partnership and, through it, to themselves.[205] In condemning this arrangement, the court stated:

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of interest, thus forcing directors to defend their transactions under the standard of entire fairness, it would have severely restricted business judgment deference, the standard generally applied in the context of negotiated acquisitions, and risked establishing Delaware courts as "super directors." *See, e.g., In re* RJR Nabisco, Inc. Shareholders Litig., Civ. A. No. 10389, 1989 Del. Ch. LEXIS 9, at *41 n.13 (Del. Ch. Jan.31, 1989) (Chancellor Allen) ("To recognize in courts a residual power to review the substance of business decisions for 'fairness' or 'reasonableness' or 'rationality' where those decisions are made by truly disinterested directors in good faith and with appropriate care is to make of courts super-directors."); *accord* Brehm v. Eisner, 746 A.2d 244 (Del. 2000) (explaining that limiting the business judgment rule "invite[s] courts to become super-directors, measuring matters of degree in business decisionmaking").

[201] *See supra* note 18 (providing measurements of percentage underpricing and aggregate dollars "left on the table") and note 141 (addressing the materiality of spinning allocations in the hands of the recipient).

[202] *See Technicolor*, 663 A.2d at 1151 ("'Material' in this setting refers to a financial interest that in the circumstances created a reasonable probability that the independence of the judgment of a reasonable person in such circumstances could be affected to the detriment of the shareholders generally.").

[203] *See* Mark D. Seltzer, *Spinning Hot Stocks: Is It a Crime?*, BUS. CRIMES BULL.: COMPLIANCE & LITIG., Sept. 1998, at 7, 8 (1998) (discussing the viability of spinning prosecutions under state commercial bribery and other criminal statutes and concluding that proof problems would overwhelm most prosecutions). *See also* John C. Coffee, Jr., *"Spinning" for Dollars: IPO's and Allocation of Hot Issues*, N.Y.L.J., Mar. 26, 1998, at 5 (stating that spinning "practices are fraught with obvious conflicts of interest – and in extreme cases could even amount to commercial bribery").

[204] 812 F. Supp. 1562 (M.D. Ala. 1993).

[205] *See id.* Interestingly, the commitment fees paid in *Enstar* arose in connection with Michael Milken's junk bond financings. Under this arrangement,

> Investing corporate funds in junk bonds with high interest rates certainly may be a legitimate act by an investment manager. It is the manager's duty however, to see that his corporation receives the full benefit of the transaction, and this would include fees paid for making a commitment to invest the corporate funds. The president of a corporation has no more right to personally receive hundreds of thousands of dollars for commitments to invest millions of his corporation's dollars than the company's purchasing agent has to take kickbacks from a firm from whom he buys supplies. The principle is the same: the person's duty to the corporation must be exercised without thought of personal gain.[206]

There is a close analogy between these commitment fees and an allocation of spun shares in the context of an IPO. Each involves an allocation of cost to the corporate entity – as risk or, in the context of spinning, foregone capital – and an allocation of benefits to the managers themselves in the form of a commitment fee or spun shares. This allocation of costs and benefits plainly enriches the manager at the expense of her shareholders and, unless approved or ratified,[207] will likely amount to a duty of loyalty violation.[208]

Each of these cases can be used to argue that spinning amounts to a breach of the duty of loyalty. When managers accept spinning allocations, they exploit the corporation they manage and impose agency costs on their shareholders by conceding to a suboptimally priced offering. In return, the managers receive the benefit of underpriced shares. This

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investors agreed to purchase junk bonds in exchange for a commitment fee. Whether the investors were ultimately obliged to purchase the junk bonds depended upon whether the activity subject to the financing, usually a hostile takeover attempt, succeeded. If the takeover went forward, the investors were required to purchase an allocation of bonds. However, the commitment fee was paid to the investors regardless of whether the financing went forward.

[206] *Id.* at 1571.

[207] Those conflict transactions that do not meet the exacting standard of entire fairness may nevertheless be upheld if approved by disinterested directors or ratified by shareholders. *See, e.g.*, CAL CORP. CODE § 310 (2003); DEL. CODE ANN. tit 8, § 144(a) (2003); N.Y. BUS. CORP. LAW § 713(a)-(d) (Consol. 2003); MODEL BUS. CORP. ACT §§ 8.60-63 (1999). *See also* Marleen A. O'Connor, *How Should We Talk About Fiduciary Duty? Directors' Conflict-of-Interest Transactions and the ALI's Principles of Corporate Governance,* 61 GEO. WASH. L. REV. 954, 956 (1993) ("Although the provisions vary widely, most state statutes are worded so that a contract with a director will not be voidable if it is approved by either disinterested directors or shareholders, or if it is fair to the corporation at the time it is made.").

[208] *See also* O'Malley v. Boris, Civ. A. No. 15735-NC, 2002 Del. Ch. LEXIS 33 (Del. Chancery, March 18, 2002) (finding that a brokerage firm breached its duty of loyalty in connection with a *quid pro quo* arrangement where the firm deposited client accounts with a particular bank in exchange for the bank giving the firm a free equity interest in a joint venture between the two).

presents a material conflict of interest similar to commission arrangements consistently found to violate the duty of loyalty.

D. Which Investors?

As discussed in the preceding sections, the harm of spinning is neither that it unfairly disadvantages individual investors in the allocation process nor that it enables managers to usurp corporate opportunities. Rather, through its connection to underpricing, spinning results in the failure of the issuer to maximize its capital-raising efforts, thus undermining the principle of shareholder wealth maximization.[209] Worse, as a manifestation of the agency cost problem and a probable breach of the duty of loyalty, spinning essentially enables managers to appropriate shareholder wealth for themselves. This plainly harms the issuer's shareholders. But, the question remains, *which* shareholders? Of all of the shareholders of the issuer, which have been harmed by spinning? And which shareholders should therefore have standing to assert claims against the corporation or its managers?

Investors may have become shareholders of the issuer either (1) *after* the IPO, by purchasing shares in the aftermarket, (2) *in* the IPO, by buying shares from the underwriter at the offering price, or (3) *before* the IPO, by investing in the issuer prior to the public offering. Each of these categories of shareholders is situated differently with respect to the harm of spinning.

1. Investors Acquiring the Issuer's Shares Through the Secondary Market

Investors who acquired shares of the issuer after the IPO – that is, by purchasing shares in the secondary market – probably suffer no harm from spinning. This Article has argued that the harm of spinning lies in its connection to the

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[209] This article follows the standard approach in corporate law scholarship in treating shareholder wealth maximization as the fundamental purpose of corporate law. *See generally* Stephen M. Bainbridge, *In Defense Of The Shareholder Wealth Maximization Norm: A Reply To Professor Green*, 50 WASH. & LEE L. REV. 1423 (1993) ("Shareholder wealth maximization long has been the fundamental norm which guides U.S. corporate decisionmakers."). Most of its conclusions regarding the destructiveness of spinning, however, should comport with any corporate law theory, except perhaps one that stresses CEO welfare maximization.

underpricing of the issuer's shares in the offering. Once those shares arrive on the secondary market, however, their price no longer bears any relation to the offering price or perhaps, as some have suggested, any relation to reality.[210] It is therefore difficult to argue that any harm suffered by the issuer (by failing to price its shares at aftermarket demand) was also suffered by those who purchased shares in the secondary market (at prices determined by aftermarket demand). Furthermore, by the time secondary market buyers purchased shares of the issuer, full information regarding the offering price and aggregate proceeds of the IPO would have been disclosed to the market through the issuer's prospectus.[211] As a result, such buyers made their decisions with full knowledge of the amount of capital raised by the issuer and arguably accepted the underpricing of the IPO by buying notwithstanding the issuer's suboptimal capital raising. Simply stated, the underpricing of the issuer's shares in the offering either does not affect secondary market purchasers at all (because they did not buy shares in the offering) or it bears their implicit assent (because they purchased the issuer's shares with full knowledge of exactly how much capital was raised in the offering).[212]

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[210] Andres Rueda, *The Hot IPO Phenomenon and the Great Internet Bust*, 7 FORDHAM J. CORP. & FIN. L. 21, 54 (2001) (with respect to the market for internet IPOs).

[211] *See* Securities Act Rule 434, 17 C.F.R. 230.434 (2002) (stating the mechanisms for final prospectus delivery and noting that a prospectus may be completed by the addition of a term sheet including price information).

[212] There is an argument that secondary market purchasers are harmed by spinning because it builds enthusiasm for the issuer's shares in the aftermarket by taking advantage of noise trading. *See supra* note 59 (discussing the availability heuristic and cascades); *see generally* Fischer Black, *Noise*, 41 J. FIN. 529 (1986) (discussing implications of noise trading in capital markets); J. Bradford de Long et al., *Noise Trader Risk in Financial Markets*, 98 J. POL. ECON. 703 (1990) (same). A shareholder who bought shares in such a market might claim that she was harmed by spinning because it created the necessary conditions for underpricing in the initial issuance, which were then exploited to *over*-inflate the price of secondary market shares. This argument, however, is a bit of a stretch. Just as signaling is an unlikely explanation for underpricing because it is too easy to imitate, underpricing probably cannot be reliably used to influence the price of shares on the secondary market. If markets are truly noisy, the issuer cannot be confident that the false signal of underpricing will be successfully received. And if arbitrageurs and other market professionals are aware that underpricing is being relied upon as a false signal for value, they will act to correct any subsequent mispricings. *See* Gilson & Kraakman, *supra* note 58. *See also supra* Part III.A.1.

2. Investors Acquiring the Issuer's Shares in the Offering

If spinning does not seem to have harmed shareholders who purchased their shares in the secondary market following an IPO, it is even less likely to have harmed shareholders who purchased their shares at the offering price in the IPO. In fact, because spinning promotes underpricing, which by definition allows buyers in the offering to pay less for their shares, it arguably *benefits* those who bought their shares in the IPO. If unencumbered by anti-flipping restrictions, these shareholders may be able to get an immediate return on their investment by selling in the aftermarket. Moreover, even those who do not sell in the immediate aftermarket will not have been harmed by the issuer's failure to maximize capital raised in the offering because, though it means they share in fewer total assets at the corporate level, they paid less for the privilege. The pie may be smaller, in other words, but a proportionally equal slice costs less. Furthermore, information on the price and proceeds raised in the offering will have been fully disclosed in the issuer's prospectus before the commitment to buy became binding. If the buyer is unhappy with the amount of capital raised in the offering, she can elect not to go through with her purchase. But instead, IPOs at the offering price tend to be viewed as prized investments, and most buyers are likely to want a larger allocation, especially if the shares are underpriced.

3. Investors Acquiring the Issuer's Shares Prior to the Offering

Although it does not seem to harm shareholders who acquired their equity interest in the issuer either during or after the IPO, underpricing is demonstrably harmful to those shareholders who had an ownership interest in the issuer prior to the IPO. Moreover, they suffer regardless of whether the issuer responds to underpricing by reducing the proceeds raised in the offering and holding constant the number of shares sold (the "float") or by increasing the float and maintaining the same aggregate offering proceeds. In the first case, the dilution of the shareholder's percentage stake does not increase but it is worth less, and in the second case, the shareholder's stake is diluted. In either case, the value of the shareholder's investment decreases.

The pre-IPO shareholder's loss can be illustrated with a simple numerical example. Imagine an investor, Alice, who has invested $100,000 for 10,000 shares of a start-up firm, Wonderland.com. After a few years of operations, Wonderland.com has accumulated $10,000,000 in assets and is poised to expand. At this time, Alice's 10,000-share stake represents one percent of the company. Wonderland.com would like to double in size through the offering, raising another $10,000,000, again at ten dollars per share, to grow to a total of $20,000,000 in assets. The first thing to note is that without underpricing and subject to the customary simplifying assumption of no transaction costs, Alice's wealth will not be affected although her stake will be diluted. Her 10,000 shares will represent a 0.5 percent rather than a one percent stake in the company, but 0.5 percent of a company with $20,000,000 in assets is worth $100,000, the same amount that her one percent stake had been worth before the offering.

Alice's wealth changes, however, as soon as underpricing is introduced. And it changes for the worse. If, instead of pricing the shares at ten dollars each, Wonderland.com agrees with its bankers that the issue should be sold for nine dollars per share, Wonderland.com faces a choice. It can either (1) raise the $10,000,000 as planned by selling more shares, or (2) reduce the amount of proceeds it will raise but keep the float constant, at 1,000,000 shares. If Wonderland.com chooses to keep the float constant but reduce the offering proceeds, it will sell 1,000,000 shares at nine dollars each and raise $9,000,000. This will not further dilute Alice, but it will reduce the value of her investment. She will have, as she expected, a 0.5 percent stake in Wonderland.com after the IPO. But the total assets of Wonderland.com will be only $19,000,000, and Alice's stake will be worth only $95,000, rather than $100,000.

If, instead of selling the same number of shares but raising less in the offering, Wonderland.com decides to hold to its target for aggregate proceeds by selling more shares, as a result of pricing the offering at nine dollars instead of ten dollars, it must sell an additional 111,111 shares to raise $10,000,000. In this case, Alice's ownership stake will be diluted and her wealth will be reduced. Her 10,000 shares will represent only 0.47 percent of the total (2,111,111) shares of Wonderland.com. As planned, the company will still have $20,000,000 in assets at the conclusion of the offering, but the value of Alice's stake will be worth less, down to approximately

$94,737 from $100,000. Either way, the underpricing of the Wonderland.com offering plainly leaves Alice worse off.

Spinning, because it is a cause of and contributing factor to underpricing, is integrally involved in decreasing the wealth of pre-IPO shareholders. Interestingly, although managers frequently lament the fees paid in IPOs and occasionally acknowledge underpricing as a problem, they appear largely unaware of or unwilling to acknowledge the harms suffered by pre-IPO owners.[213]

V. RIGHTING THE WRONGS

A. *Shareholder Litigation*

Because Alice and those like her – that is, those investors who were shareholders of the issuer prior to the IPO – can show that they have been harmed by spinning, they should have standing to assert a claim against the corporation or its managers.[214] What, then, should be their remedy? Before undertaking to answer this question, however, it is worth noting that not every pre-IPO investor is like Alice. Many pre-IPO investors are sophisticated venture capitalists who presumably understand the dynamics of spinning and underpricing. Moreover, venture capitalists themselves were such common recipients of spinning allocations that a trade group, the National Venture Capital Association, circulated a memo to its members warning them that by engaging in spinning, they risked stirring regulatory and prosecutorial zeal.[215] It therefore may be safe to assume that even if they did not necessarily participate in spinning themselves, these investors knew about it and condoned it.[216]

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[213] *See* Ryan & DeGraw, *2002 Study*, *supra* note 71, tbl.5b & tbl.7 (showing that in spite of their concern for the cost of the offering, well under 50% of CFOs agree with the statement that substantial appreciation in share price on the first day of trading represents losses for original owners or original shareholders).

[214] *See generally* DEL. CODE ANN. tit. 8 § 327 (2003) (requiring for standing in a derivative suit that the plaintiff was a stockholder of the corporation at the time the harm that is the subject of the complaint occurred).

[215] Michael Siconolfi, *IPO Market: Surviving the Storm – Venture Capitalists Get a Stern Warning on "Spinning" IPOs*, WALL ST. J., Nov. 17, 1997, at C16 (quoting a group member's characterization of the message: "Times are good. Let's all not get greedy, and remember an ounce of prevention is worth a pound of cure.").

[216] Professor Coffee has suggested that sophisticated market participants had a relationship to spinning like the relationship of the authorities to gambling at Rick's Café Américain in the film *Casablanca*, in which Claude Rains, as Inspector Renault, remarked "I'm shocked, shocked to learn that gambling is going on here," as he

Of course, not every pre-IPO investor is a sophisticated venture capitalist, and not every venture capitalist knows about or approves of spinning. But note how small the universe of harmed shareholders has become. It excludes those who bought in the secondary market or in the offering itself. It excludes the main source of pre-IPO financing, sophisticated venture capital funds who knew about and understood spinning. And it excludes the managers themselves, another major contingent of pre-IPO shareholders who, because of their unclean hands, are rightly excluded from the class of shareholders damaged by the practice. The remaining shareholders, after all of these groups have been excluded, is a relatively small number of unsophisticated pre-IPO investors. Nevertheless, like Alice, they appear to have been genuinely harmed by the actions of their managers. What is their remedy?

Alice and similarly situated pre-IPO investors have a derivative claim against those issuers whose managers engaged in spinning in connection with their IPO.[217] Because Alice's financial loss from spinning is merely a proportional share of the loss to the corporation, she may only pursue her claim through the corporation[218] and seek to compel the corporation to sue its disloyal managers, rather than filing a direct claim against them.[219] In order for the derivative claim to go forward against the managers, the shareholder must first demand that the corporation pursue it, leaving the decision of whether to seek redress to the discretion of the board of directors, the decision of which, for all practical purposes, is

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pocketed his winnings for the evening. CASABLANCA (Metro-Goldwyn-Meyer 1942), *cited in* John C. Coffee, Jr., *The IPO Allocation Probe: Who is the Victim?,* N.Y.L.J., Jan. 18, 2001, at 5.

[217] A claim is derivative when the shareholder's loss is the result of a loss to the corporation. *See, e.g.,* Daily Income Fund, Inc. v. Fox, 464 U.S. 523, 528 (1984) (quoting Hawes v. Oakland, 104 U.S. 450, 460 (1881) (an action is derivative if it is "found on a right of action existing in the corporation itself, and in which the corporation itself is the appropriate plaintiff"). Suits alleging inadequacy of consideration in the issuance of stock are derivative suits. *See* Bennett v. Breuil Petroleum Corp., 99 A.2d 236, 241 (Del. Ch. 1953).

[218] *See generally* Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949) (a derivative action permits a shareholder to "step into the corporation's shoes and to seek in its right the restitution he could not demand on his own").

[219] *See* Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) (a derivative action "is the equivalent of a suit by the shareholders to compel the corporation to sue" as well as "a suit by the corporation, asserted by the shareholders on its behalf, against those liable to it").

final.[220] The law's preference for corporate decision-makers over injured shareholders in this context has occasionally been a source of consternation among commentators,[221] but recalls the principle that absent a clear conflict of interest, directors are given discretion to manage the corporation in the best interests of its shareholders.[222]

It would not be surprising, under the facts as this Article has presented them, if the issuer's board elected not to pursue shareholders' claims relating to spinning. First, assuming that the guilty managers do not eagerly volunteer the several million dollars in offering proceeds foregone by the issuer in connection with spinning and underpricing, the corporation will be forced to pursue its managers in court. This is a costly endeavor.[223] In addition to destroying any working relationship with what might otherwise be a perfectly competent, even exceptional set of managers,[224] the litigation itself will be extraordinarily expensive, since managers are likely to have adequate resources to mount a vigorous defense.[225] Moreover, full recovery, as measured by the marginal

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[220] Because the corporation's decision to sue, when made by a disinterested majority of the board, is insulated by the business judgment rule, shareholders can expect little success in challenging it. *See* ROBERT CHARLES CLARK, CORPORATE LAW 641 (1986) ("Whether to sue or not is ordinarily a matter for the business judgment of directors, just as is a decision that the corporation will make bricks instead of bottles.").

[221] *See generally* Charles Hansen, *The Duty of Care, the Business Judgment Rule, and the American Law Institute Corporate Governance Project*, 48 BUS. LAW. 1355 (1993).

[222] The underlying principle of the demand mechanism is that:

> directors, rather than shareholders, manage the business and affairs of the corporation . . . . The decision to bring a lawsuit or to refrain from litigating a claim on behalf of a corporation is a decision concerning the management of the corporation.

Spiegel v. Buntrock, 571 A.2d 767, 772-73 (Del. 1990); *see also* Levine v. Smith, 591 A.2d 194, 200 (Del. 1991) ("The directors of a corporation and not its shareholders manage the business and affairs of the corporation, and accordingly, the directors are responsible for deciding whether to engage in derivative litigation.") (citations omitted).

[223] *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 265 (Del. 2000) (weighing the costs of litigation against a convincing argument that the CEO's conduct constituted gross negligence).

[224] This loss of human capital must be factored into the costs of pursuing the spinning claim. If the managers who engaged in spinning are no longer with the firm, the cost to human capital will be less direct, but not necessarily less severe. A firm that shows its willingness to pursue such claims against its former managers can expect to have difficulty recruiting future managers in the labor market. *See generally* Edward B. Rock & Michael L. Wachter, *The Enforceability of Norms and the Employment Relationship*, 144 U. PA. L. REV. 1913 (1996) (describing how the norms of the labor market structure the employment relationship).

[225] As noted above, the legal analysis of spinning is based upon analogies to secret commissions and other duty of loyalty cases. *See supra* Part IV.C. And the

amount of underpricing in the offering, is unlikely for the simple reason that many managers, even CEOs and CFOs of public companies, may not have sufficient assets to reimburse the firm for foregone offering proceeds.[226] Once recovery is discounted by the probability of success and the likelihood of payment minus litigation costs, the pursuit of such claims may no longer be a positive net present value undertaking.[227] Disinterested directors arriving at this conclusion may thus elect not to pursue these claims and may use the demand mechanism to prevent shareholder claims from going forward.[228]

As a result, although a derivative claim against managers for breach of the duty of loyalty in connection with

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theoretical basis of the claim – that managers' acceptance of spinning allocations was part of an arrangement that harmed the issuer by leading to greater underpricing in the offering – is difficult to prove empirically. *See supra* Part III.C.

[226] The damage done to the corporation and its shareholders by spinning might be measured by the aggregate amount of its underpricing (the harm to the corporation) rather than the value of the managers' spinning allocation (the benefit to the manager). Refinements to this formula might seek to exclude underpricing stemming from the motives discussed in Part III that suggest a benefit to the issuer from narrow (10-15%) underpricing. *See supra* note 94 and accompanying text. Spinning appears to relate primarily to outsized underpricing, especially that observed in the late 1990s. *See* Ritter & Welch, *Review*, *supra* note 118, 1810-11. As a result, it might be more appropriate to measure the harm of spinning by the amount of any *excess* underpricing – that is, underpricing greater than the cross-market average of 10-15%.

[227] In addition, the dynamics of such litigation strongly favor settlement over adjudication. If the issuer pursues a claim against its executives, the executives may seek to settle while the claim is still covered under the firm's directors and officers ("D&O") insurance policy, as it generally would be, so long as the claim is settled without admitting that the managers violated their duties of good faith and fair dealing. *See* Michael Sean Quinn & Andrea D. Levin, *Directors' and Officers' Liability Insurance: Probable Directions in Texas Law*, 20 REV. LITIG. 381, 403 (2001). Any settlement paid out of the firm's D&O policy, however, ought to result in an increase in the firm's insurance premiums and, in this way, ultimately be paid in large part by the firm itself.

[228] *See* John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 LAW & CONTEMP. PROB. 5 (1985); Reinier Kraakman et al., *When Are Shareholder Suits in Shareholder Interests?*, 82 GEO. L. J. 1733, 1736 (1994) (arguing that "a derivative suit increases corporate value in two circumstances: if the prospect of suit deters misconduct or, alternatively, if the suit itself yields a positive recovery net of all costs that the corporation must bear as a consequence of suit"); Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J. L. ECON. & ORG. 55 (1991) (offering an empirical analysis of shareholder suits and finding that shareholder suits neither offer meaningful monetary recoveries nor improve corporate governance). At the conclusion of her empirical study, Romano emphasized the following:

> There are financial recoveries in only half of settled suits, and per share recoveries are small . . . . The principal beneficiaries of the litigation . . . appear to be attorneys, who win fee awards in 90 percent of settled suits. There is little evidence of specific deterrence . . . . There is scant evidence that lawsuits function as an alternative governance mechanism of the board.

Id. at 84-85.

spinning ought to be available, it would be unsurprising if the remedy was rarely, if ever, pursued.

B. Regulatory Efforts

Even if, as the last section argued, derivative claims are unlikely to be pursued and injured shareholders are unlikely to be compensated, spinning nevertheless constitutes a serious harm to the corporation, the capital-raising process, and investor welfare. It ought to be stopped.

In recent months a number of regulatory initiatives have targeted the practice of spinning. This section addresses the regulatory approaches currently under consideration, including the Voluntary Initiative resulting from the so-called Global Settlement and the activities of SRO rule-making and advisory bodies.

1. Voluntary Initiative Concerning Spinning

In April 2002, New York State Attorney General Eliot Spitzer filed an action under an old New York state law, the Martin Act,[229] against several major investment banks in connection with investment analyst conflicts of interest.[230] The SEC, NASD, NYSE, and a number of other state Attorneys General later joined Spitzer in negotiating a settlement with the investment banks, culminating in the so-called Global Settlement, finalized a year later, in April 2003.[231] In addition

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[229] The Martin Act broadly prohibits any device, scheme, or artifice to defraud by means of false pretense, representation or promise, and any concealment, suppression, fraud, false pretense or false promise in connection with the sale of securities or in connection with the offering of investment advice. *See* N.Y. GEN. BUS. L. § 352(1) (Consol. 2003).

[230] *See generally* Affidavit of Eric R. Dinallo in Support of Application for an Order Pursuant to General Business Law 354, *In re* An Inquiry By Eliot Spitzer, at 3 (N.Y. Sup. Ct. Apr. 2002) (Index No. 02-4015-22). This use of the Martin Act has been a source of controversy among commentators. *See generally* Charles Gasparino, *New York Sues Telecom Executives Over Stock Profits: Attorney General Spitzer Seeks Return of $1.5 Billion, Citing Salomon Dealings,* WALL ST. J., Oct. 1, 2002, at A1 (quoting Professor Coffee to state that the enforcement action is "unprecedented" and that there is "no logical connection" between Salomon Smith Barney analyst Jack Grubman's rating on WordCom stock and Ebbers' IPO allotments, as asserted by the Martin Act claim); Tamara Loomis, *Attorney General Accuses Executives of 'Spinning' Stock,* N.Y.L.J., Oct. 1, 2002, at 1 (quoting statement by David J. Kaufman, co-author of McKinney's Commentary on the Martin Act, that the enforcement action is "brand new, fascinating and compelling").

[231] Joint Press Release, Securities Exchange Commission, New York Stock Exchange, National Association of Securities Dealers, North American Securities Administrators Association, and New York State Attorney General's Office, Ten of

to the settlement of the conflict of interest investigation, each party to the Global Settlement was encouraged to enter into a "Voluntary Initiative Regarding Allocations of Securities in 'Hot' Initial Public Offerings to Corporate Executives and Directors."[232]

Under the Voluntary Initiative, investment banks would agree not to allocate hot IPO shares "to an account of an executive officer or director of a U.S. public company"[233] and further agree not to "allocate securities in an IPO in exchange for or for the purpose of obtaining investment banking business."[234] The Voluntary Initiative thus plainly targets certain practices that fall under the rubric of spinning[235] and tailors a set of definitions to capture and forbid them.

However, in focusing on the spinning of IPO shares to the executives of *public* companies,[236] the Voluntary Initiative misses the harm of spinning that is the central thrust of this Article – that is, the harm to the issuer and its shareholders when spinning allocations are doled out to pre-public executives in exchange for concessions on offering price. Executives receiving such allocations are, when the allocations are made, managers of *private* companies. The allocations are inducements to make concessions on offering price when the company goes public. By the time the company has gone public – that is, has made its IPO[237] – its managers will be barred from receiving spinning allocations, but by then it is too late. The allocation arrangement and concomitant quid pro quo would have been entered into prior to the public offering – that is, before the managers are excluded under the Voluntary

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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.

[232] *See* Press Release, Securities Exchange Commission, Voluntary Initiative Regarding Allocations of Securities in 'Hot' Initial Public Offerings to Corporate Executives and Directors [hereinafter *Voluntary Initiative*], *available at* http://www.sec.gov/news/press/globalvolinit.htm (last modified Mar. 28, 2003).

[233] *Id.* at para. 1.

[234] *Id.* at para. 3.

[235] *See supra* notes 44-47 and accompanying text (discussing IPO allocations to public company managers in exchange for investment banking business).

[236] The Voluntary Initiative defines "public company" as "any company that is registered under Section 12 of the Securities Exchange Act of 1934 or files periodic reports pursuant to Section 15(d) thereof." *See Voluntary Initiative*, *supra* note 232, at para. 1.

[237] By making an IPO, the company will come under either § 12 or § 15(d) of the Exchange Act and thus be captured by the Voluntary Initiative's definition of "public company." *See id.*

Initiative from receiving IPO allocations. As a result, the Voluntary Initiative, as currently drafted, is unlikely to constrain the harmful allocation practices identified in this Article.

2. SRO Rule-Making

In addition to the Voluntary Initiative, the NYSE and NASD have undertaken regulatory efforts designed to end the practice of spinning.

In May 2003, an IPO Advisory Committee convened by the NYSE and NASD issued a set of recommendations designed to improve the integrity of the IPO process.[238] Although the committee could not agree that IPOs in the late 1990s were deliberately underpriced to create spinning opportunities,[239] a number of their recommendations are designed to eliminate the ability of underwriters to enter into quid pro quo arrangements in connection with IPO allocations. The recommendations seek to arrive at this result by taking away the structural features that enable the creation of such arrangements, including inside management's control over the pricing negotiation[240] and the underwriter's information asymmetries in the book-building process.[241] Also along these lines, the recommendations seek to end the unequal imposition of anti-flipping restrictions – that is, the tendency of underwriters to limit the ability of individuals, but not institutions, to resell their shares[242] – and to encourage the development of Dutch auctions and other alternatives to the

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[238] *See* NYSE/NASD IPO ADVISORY COMMITTEE REPORT AND RECOMMENDATIONS, May 2003 [hereinafter ADVISORY COMMITTEE REPORT], *at* http://www.nasdr.com/pdf-text/ipo_report.pdf.

[239] *See id.* at 4 n.5.

[240] The recommendations seek to require issuers to establish an IPO pricing committee with at least one non-executive member. *See id.* at 4. Reading between the lines, the insertion of outside directors into the pricing negotiations may be intended to relieve some of the temptation of inside managers to accept spinning allocations in exchange for concessions on offering price. The insertion of independent directors does not wholly alleviate the problem, of course, since underwriters can simply offer spinning allocations to the outsiders as well. However, the greater presence of others, especially those bearing the imprimatur of "independent," may constrain the tendency of managers to behave selfishly in pricing negotiations.

[241] The recommendations would eliminate the underwriter's information asymmetry in the book-building process by requiring underwriters to provide issuers with all indications of interest before the pricing meeting, thus giving the issuer a better sense of aggregate demand for the offering and increasing its ability to bargain for a better offering price. *Id.* at 5.

[242] *Id.* at 7.

book-building process.[243] Finally, in addition to proposing structural constraints on the ability of underwriters to profit through IPO allocations, the Advisory Committee also suggests an outright ban on the ability of underwriters to engage in spinning, recommending that the SEC or the exchanges:

> [p]rohibit the allocation of IPO shares (1) to executive officers and directors (and their immediate families) of companies that have an investment banking relationship with the underwriter, or (2) as a *quid pro quo* for investment banking business.[244]

The Advisory Committee supports a "clear prohibition on spinning"[245] and cites changes in the NASD's rules regulating IPO allocations as "a starting point."[246]

The NASD regularly revises the rules governing the IPO process.[247] Proposed New Rule 2712, first introduced in August 2002,[248] and substantially revised in November of 2003 in response to the Advisory Committee's recommendations,[249] represents a significant effort to tighten the regulation of the

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[243] The recommendations seek to encourage alternatives to book-building through the removal of regulatory constraints. ADVISORY COMMITTEE REPORT, *supra* note 238, at 9. Dutch Auctions foreclose the possibility of spinning by essentially removing the underwriter from the offering process. In a Dutch Auction, each would-be investor submits a bid for a certain amount of shares at a certain price. These bids are then arranged in order of highest price to lowest, with the issuer accepting each offer to buy until it has sold out the offering. The last offer to buy that the issuer accepts – i.e., the final order necessary to sell out the offering and, because it is farthest down the list, the lowest offer – is the price paid by *all* bidders. *See generally* Note, *Auctioning New Issues of Corporate Securities*, 71 VA. L. REV. 1381 (1985) (noting that the mechanism solves the hold-out problem since low-ball bidders will not receive allocations of an oversubscribed offering). By cutting out the underwriter's ability to make allocations, the Dutch Auction method eliminates all harms associated with the spinning of IPOs. However, it also cuts out the ability of underwriters to add value to the IPO process by, for example, certifying issuer quality. *See generally* Booth & Smith, *Capital Raising*, *supra* note 23. Moreover, Dutch Auctions may not address every possible cause of underpricing. *See* Coffee, *supra* note 18, at 6 ("[I]f . . . IPO underpricing results primarily from day trading excesses or systematic biases in the market, Dutch Auctions may prove unsuccessful [solutions] . . .").

[244] *See* ADVISORY COMMITTEE REPORT, *supra* note 238, at 10.

[245] *Id.* at 10.

[246] *Id.*

[247] *See generally supra* note 39 (discussing a set of amendments to the Free-Riding and Withholding Rules in the late 1990s).

[248] *See* NASD Regulation, Inc., NASD Notice to Members (02-55), Regulation of IPO Allocations and Distributions: NASD Requests Comment on Proposed New Rule 2712 (IPO Allocations and Distributions) and on an Amendment to Rule 2710 (Corporate Financing Rule) (Aug. 2002) [hereinafter *Proposed Rule Notice*].

[249] *See* NASD Regulation, Inc., NASD Notice to Members (03-72), Proposed Rule Governing Allocations and Distributions of Shares in Initial Public Offerings, Request for Comment on Regulatory Approaches to Enhance IPO Pricing Transparency (Nov. 2003) [hereinafter *Proposed New Rule Amendment*].

offering process and restrict the practice of spinning. Proposed New Rule 2712 targets spinning by prohibiting allocations of IPO shares either on the condition of future investment banking business or in consideration of past investment banking business.[250] A number of the recent amendments to the Proposed New Rule are direct outgrowths of the Advisory Committee's report, including a requirement that information gathered by the underwriter during the book-building process be shared with the issuer,[251] procedures implemented to prevent reneged IPO allocations from being used to benefit specific individuals,[252] and rules imposing lock-up periods on issuer-directed shares.[253] The Proposed New Rule Amendment also follows the Advisory Committee in emphasizing alternatives to the traditional book-building process, requesting comment on the use of an independent intermediary in the pricing process, the development of an auction system, and the value of increased disclosure in the prospectus regarding the pricing decision.[254]

Although the Proposed New Rule is a significant effort aimed at ending the practice of spinning, it complicates the issue by regulating the practice on the basis of *intent* – that is, whether the allocation is intended by the underwriter to induce or reward investment banking business.[255] The underwriter's defense – that the allocation was the result of an ordinary

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[250] NASD Proposed New Rule 2712(c) states:

> No member or person associated with a member may allocate IPO shares to an executive officer or director of a company: (1) on the condition that the executive officer or director, on behalf of the company, direct future investment banking business to the member, or (2) as consideration for directing investment banking services previously rendered by the member to the company.

Proposed Rule Notice, supra note 248, at Exhibit A.

[251] NASD Proposed New Rule 2712(e)(1)(A), *Proposed New Rule Amendment, supra* note 249, at 778. This corresponds to the Advisory Committee recommendation. See discussion *supra* note 241 and accompanying text.

[252] NASD Proposed New Rule 2712(e)(2), *Proposed New Rule Amendment, supra* note 249, at 779.

[253] NASD Proposed New Rule 2712(e)(1)(B), *Proposed New Rule Amendment, supra* note 249, at 778. *See also supra* note 7 (discussing issuer-directed shares). Interestingly, the Proposed New Rule does not require, as the Advisory Committee had recommended, that anti-flipping restrictions be imposed equally on all individuals as well as on institutions.

[254] *Proposed New Rule Amendment, supra* note 249, at 776-77.

[255] The NASD has emphasized that "[t]he provision is not intended to prohibit a member from allocating IPO shares to a customer merely because the customer is an executive officer or director of a company." *Proposed Rule Notice,* supra note 248, at 524-25.

customer relationship rather than an attempt to curry favor with the executive's company – is predictable and may be expensive to defeat.[256] Foreseeing these issues, the NASD has also proposed amending existing Rule 2710 to require underwriters to retain information regarding whether issuer-managers have received any IPO allocations from the underwriter during the six-month period preceding their offering.[257] Although this does not completely solve the problem of proving intent, this information could be used, in comparison with the underwriter's ordinary brokerage allocations, to argue that the allocation to an issuer's manager was out of the ordinary, perhaps supporting a presumption of an intent to influence in violation of the Proposed New Rule.

It is worth pausing to consider whether additional rule making is necessary at all given the NASD's existing prohibitions against gratuities. NASD Rule 3060 prohibits members from giving "anything of value, including gratuities, in excess of one hundred dollars per individual per year" to anyone "in relation to the business of the employer of the recipient of the payment or gratuity."[258] This rule against gratuities could be read to prohibit spinning allocations since an opportunity to invest in a hot IPO would seem to qualify as something "of value" and, according to the account of spinning developed in this Article,[259] the corporate manager receives the allocation as a result of his position within his firm.[260]

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[256] *See, e.g.*, Letter from Kenneth L. Josselyn, Chair of the Capital Markets Committee of the Securities Industry Association, to Barbara Z. Sweeney, Office of the Corporate Secretary of the NASD 3 (Sept. 24, 2002) (conveying comments of the Securities Industry Association and noting that "the line between what is 'excessive' or what has been done as or on 'a condition' or 'as consideration' for something can be difficult to draw"), *available at* http://www.sia.com/2002_comment_letters/pdf/ipo.pdf.

[257] *See* Proposed Amendment to Rule 2710(b)(6)(vii), *Proposed Rule Notice*, *supra* note 248, at Exhibit B.

[258] National Association of Securities Dealers, Inc., NASD Manual Conduct Rules, Rule 3060 (2003). Similarly, NYSE Rule 350(a) limits gratuities given by members to "to principals, officers or employees of the Exchange or of other members or member organizations or of securities, commodities or news and financial organizations." Self-Regulatory Organizations; New York Stock Exchange, Inc.; Order Approving Proposed Rule Change Relating to Amendments to Rule 350, Compensation or Gratuities to Employees of Others, Exchange Act Release No. 34-30877, 57 Fed. Reg. 30,283 (July 8, 1992) (approving increase on gratuities limitation from $50 to $100 per year). The class of recipients barred from the receipt of gratuities under the NASD Rule is broader than that under the NYSE, including anyone receiving a gift "in relation to the business of [his] employer" while the NYSE Rule focuses primarily on recipients in some relationship with the Exchange. As a result, the NASD Rule is more likely to cover gratuities to corporate managers.

[259] *See supra* Part II.B.

[260] *See, e.g.*, NASD Quattrone Complaint, *supra* note 145 (alleging that "the

There are, however, at least two hurdles to the use of NASD Rule 3060 to prevent spinning. First, although IPO allocations are plainly something "of value," they may not fit within the overall focus of the rule on gratuities for the simple reason that the recipients of an IPO allocation must pay for their shares. In arguing that IPO allocations are like gratuities, the enforcer would need to focus attention on the difference between the offering price and the aftermarket price as the gratuity or "value" involved. Although there is some precedent for this argument,[261] the counterargument is also apparent – that is, that ex post share price appreciation is uncertain ex ante and that purchasing shares in an IPO involves precisely that risk and therefore ought not to be treated as gratuity or plain "value." Second, Rule 3060, like Proposed New Rule 2712, focuses on the intent of the donor, creating proof problems and potentially costly litigation.[262] By contrast, the Advisory Committee has suggested a more far-reaching prohibition, asserting that "the very existence of an investment banking relationship should bar all directors and executive officers of the underwriter's investment banking client from receiving any IPO shares from the underwriter."[263]

Although none of the current rule-making proposals go as far as the Advisory Committee's recommendations in restricting the practice of spinning, they do seem to represent steps in the right direction. They are, however, not without costs. For example, under most current proposals, underwriters may be forced to litigate intent after the fact and also bear the additional burden of determining which individuals are eligible to receive IPO allocations and which individuals, due to their affiliation with the issuer or other investment banking clients, are not.[264] In the case of amply oversubscribed issues, these

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[CSFB] Tech Group's 'spinning' of IPO shares violated NASD Rule 3060, which prohibits members and associated persons from giving gratuities in excess of $100 to anyone 'in relation to the business of the employer of the recipient.'").

[261] *See, e.g.*, *In re* Black & Co., SEC Admin. Proc. File No. 3-3460, 1974 SEC LEXIS 3633, at *30-*49 (July 12, 1974) (finding that the allocation of a hot IPO constituted a gratuity, notwithstanding the fact that the share allocation was bought and paid for).

[262] In addition, the use of existing tools such as NASD Rule 3060 or the corporate opportunities or agency law doctrines noted above forces the problem of spinning into doctrinal paradigms that do not necessarily respond to the connection between spinning and underpricing nor to the subtle wealth-transfer dynamics involved in the receipt of a spinning allocation. *See supra* Part III.C.

[263] ADVISORY COMMITTEE REPORT, *supra* note 238, at 11.

[264] Although it is tempting to answer that underwriters ought to be made to

costs could be avoided by barring individual allocations altogether. This suggestion is outlined in the next section.

C. *A Proposal*

The harm of spinning is that the receipt of hot IPO allocations may induce some individuals to breach their fiduciary duties. Although this Article has focused primarily on the problem of managers who are induced to underprice their offerings, there are a wide variety of other market participants who may be induced to breach their fiduciary obligations.[265] It is therefore difficult, even in an academic treatment far removed from the time pressure of investment banking allocation decisions, to account for all of the potential conflicts that an individual purchaser may have. As a result, the most efficient way to control the harm may be to eliminate, or at least severely limit, individual participation in IPO allocations.

Eliminating the role of individual investors in hot offerings may increase the integrity of the capital markets without significantly increasing the cost of capital. This could be accomplished by phasing out the "retail pot" as IPOs become oversubscribed. The taint of corruption – that is, shares going to Bernie Ebbers rather than to you or me – would thus be eliminated from the IPO process as the stock of shares from which spinning allocations are drawn disappeared. Furthermore, barring individual allocations and, in doing so, eliminating the possibility of spinning, would effectively remove a key motivation for underpricing. Underpricing might persist, but only at the levels necessary to reward institutions for truthfully revealing demand.[266] The large underpricing spreads of the late 1990s, which grew as spinning became an increasingly common practice,[267] would no longer be necessary or possible as the source of the side payment was effectively taken away, thereby increasing the efficiency of the capital-raising process.

Notwithstanding its near certain effectiveness at removing the actual source of corruption from the IPO market,

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bear the costs of spinning, it is important to note that increasing underwriters' costs will ultimately increase the issuer's cost of capital since underwriters will seek to pass costs back to issuers and, ultimately, their shareholders.

[265] *See supra* Part II.B (listing a variety of quid pro quo relationships which may be engaged in by investment bankers allocating IPO shares).

[266] *See supra* Part III.A.4.

[267] *See supra* Part III.C.

the elimination of individual investors from heavily oversubscribed IPOs is a somewhat ironic solution.[268] It solves the structural defects of the IPO process by exacerbating the individual investor's most common complaint about the process – that is, *I* didn't get any. Eliminating the retail pot not only eliminates the ability of underwriters to ingratiate themselves with the likes of Bernie Ebbers, it also eliminates the ability of you and me directly to subscribe to hot public offerings. No individual could get the shares of hot IPOs.[269] They would all go, instead, to the pension funds of California, New York, and other states, to Vanguard and Fidelity, and other institutional investors. The exclusion of individuals from these investment opportunities will not be popular with individuals who, for one reason or another, want to participate in public offerings, making the proposal particularly unlikely to be adopted by reformers seeking to cast themselves as champions of the average investor.[270]

But the exclusion of individuals is apparent only. Individuals, after all, are the beneficial owners of institutional investment funds. They are the state employees and mutual fund holders that profit at the end of the day when these institutions flip their IPO shares for gains. At this level, much of the distinction between individuals and institutions crumbles since institutions invest for individuals. Furthermore, forcing individuals to invest in IPOs through institutions would

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[268] It is unclear how often IPOs are sufficiently oversubscribed to eliminate the role of individual investors. Moreover, the elimination of retail investors may exacerbate certain liquidity and holding structure concerns. Issuers tend to favor diffuse ownership and, relatedly, a liquid aftermarket for their shares. As one entrepreneur explained:

> The reason we've crisscrossed the country and are trying to visit as many institutional investors as possible is clear to me: We want to spread out the shares as widely as possible so that too many shares don't get concentrated in the hands of too few institutions. Thinly traded stocks have great volatility.

Mike Mills, *A Digital Age Rite: The IPO Roadshow,* WASH. POST, Nov. 28, 1999, at H1. It is possible, however, that liquidity concerns would be naturally assuaged when institutions flipped their shares to individuals.

[269] The proposal to improve the offering process by limiting or eliminating allocations to individuals is similar to proposals to improve securities regulation by regulating investor sophistication rather than issuer disclosure. *See, e.g.,* Stephen Choi, *Regulating Investors Not Issuers: A Market-Based Proposal,* 88 CALIF. L. REV. 280 (2000). *See also* Colin Camerer et al., *Regulation for Conservatives: Behavioral Economics and the Case for "Asymmetric Paternalism,"* 151 U. PA. L. REV. 1211 (2003) (making the case for regulation by default rules that sophisticated parties – those least likely to be susceptible to costly errors attributable to cognitive bias or bounded rationality – may avoid).

[270] *See supra* note 15 (comparing New York Attorney General Spitzer and United States Senator Oxley as champions of the average investor).

achieve other salutary goals such as encouraging diversification and eliminating unsystematic risk from the investment portfolios of investors who may not be sufficiently sophisticated or sufficiently wealthy to eliminate it themselves.[271] Finally, objectors to the exclusion of individuals from the IPO allocation process are in the odd position of asserting the individual rights of the wealthy – that is, those investors with enough wealth and leisure to research and invest in individual securities without regard either to the opportunity costs or transaction costs associated with managing a brokerage account – over efficiency in the capital markets and the interests of those investors who are not sufficiently sophisticated or sufficiently wealthy to attain diversification on their own.

Simply stated, if underwriters could not allocate hot issues to individual investors, many of the dubious quid pro quo relationships involved in spinning would be eliminated. Investment bankers could no longer seek to curry favor with the wealthy and the powerful over the average investor. All investors would be forced to participate on equal footing, as institutional fund-holders or, alternatively, as aftermarket buyers. Because these wealth-creating quid pro quo arrangements would no longer be available to underwriters,[272] their self-interested incentives to underprice IPOs would be diminished, and IPOs would be priced closer to aftermarket demand, perhaps with a narrow discount to induce institutional buying.[273]

Although this proposal may be politically unfeasible due to individual investors' enthusiasm for hot IPOs, it is offered here to emphasize an element of the problem – the centrality of the connection between spinning and underpricing – that other regulatory proposals avoid or gloss over,[274] and to illuminate the interests of and conflicts between the parties with respect to spinning and underpricing.

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[271] *See generally* RONALD J. GILSON & BERNARD S. BLACK, THE LAW AND FINANCE OF CORPORATE ACQUISITIONS 89-94 (2d ed. 1995) (explaining diversification).

[272] Quid pro quo allocations to institutions are already regulated and generally banned. *See supra* notes 36-39 (discussing the NASD's Free-Riding and Withholding Rules) and note 40 (discussing the prosecutions of CSFB and other investment banks for linking brokerage commissions to institutional allocations).

[273] A narrow institutional discount is consistent with the investor reward hypothesis discussed in Part III.A.4.

[274] *See supra* note 239 and accompanying text.

VI. SUMMARY AND CONCLUSION

This Article explored one of the controversies arising from the stock market boom of the late 1990s – the spinning of IPO shares – and developed a theoretical account of the practice connecting it to the well-documented phenomenon of IPO underpricing. Underpricing is both a means and an end of spinning. Underpricing enables spinning by providing underwriters with a ready supply of hot IPO shares. And underpricing is an end of spinning when hot IPO allocations are used to induce issuer-managers to underprice their own offerings. This Article found support for the link between spinning and underpricing in the literature of financial economics and in an empirical survey of pricing in offerings where spinning was reported to have occurred.

Having established this relationship between spinning and underpricing, the Article went on to consider the proper treatment of spinning under the law. At its core, spinning involves a wealth transfer from the issuer to its manager, with the underwriter merely serving as an intermediary. As a result, the practice may be conceptualized as a breach of the manager-recipient's duty of loyalty to the company. Nevertheless, this is a harm to the corporation that, having occurred, may be exceedingly costly to redress. Consequently, the harm of spinning may be more effectively eliminated through regulation of the offering process than through shareholder litigation.

Finally, this Article proposed a simple regulatory approach to the problem of spinning. Phasing out the right of individual investors to participate in offerings that had become significantly oversubscribed would solve the problem of spinning and, at the same time, eliminate a significant motivation for underpricing. The irony of this solution, however, is that it may fix the problem while failing to appease the most significant parties in interest to the offering process. The proposal suits neither underwriters, who might prefer to maintain the ability to generate goodwill through their allocation practices, nor issuer-managers, who might like to continue receiving the allocations, nor individual investors, who might simply want the opportunity to share in the gains associated with flipping a hot IPO allocation. The proposal would, however, protect the interests of issuers generally, by increasing offering proceeds, while also protecting those pre-

IPO shareholders who are most likely to be harmed by spinning and the underpricing that it entails.

Regardless of the feasibility of any particular approach, the debate surrounding the proper regulatory solution to the problem of spinning would be improved by emphasizing the connection between spinning and underpricing. This Article has sought to contribute to that debate by illuminating that link as well as the subtle wealth transfer dynamics that the practice of spinning sets in motion.