
COMMENT

INVESTOR PARTICIPATION IN INITIAL
PUBLIC OFFERINGS

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INTRODUCTION 564

I. THE MECHANICS OF AN IPO 567

 A. *Overview of the IPO Process* 567

 B. *Underpricing Theories* 570

 1. The “Winner’s Curse” 571

 2. Information Revelation 573

 3. Litigation Risk 575

 4. Summary 576

II. EXISTING REGULATIONS 576

 A. *History* 576

 B. *The Securities Act of 1933 and the Securities Exchange Act of 1934* 577

 C. *Recent Amendments* 579

III. INCREASING ALLOCATIONS TO RETAIL INVESTORS AS A CLASS 580

 A. *Overview* 580

 B. *The Dutch Auction Is Not a Desirable Solution* 581

 C. *Comparison to Creditors in Bankruptcy* 583

 D. *Trend Toward Regulation* 586

 E. *Providing Small Investors with Access to IPO Shares* 587

CONCLUSION 589

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INTRODUCTION

Eight years after Facebook's founding, when shares at its initial public offering (IPO) were priced at \$38 each, Facebook's valuation of \$104 billion made it "the most valuable U.S. company at the time of its stock market debut."¹ But in the days and weeks that followed its May 2012 IPO, the company's stock price was dropping fast, and a *Wall Street Journal* contributor commented that "[t]he newly public shares are losing an average of about \$1 per trading day since their offering. If that lasts, the social-networking company would be worth nothing before the end of June, and Chief Executive Mark Zuckerberg's trips to McDonald's will seem less chic and more necessary."² So what, if anything, went wrong?

To start, IPOs are generally "underpriced," that is, the initial offering price is usually set below fair market value such that the shares yield positive returns during secondary trading in the moments after the shares hit the market.³ But did Facebook even fail on this metric? At least for certain investors, the answer is no. Facebook shares reached a high of \$45 on the first day of trading,⁴ meaning that some investors who were able to buy Facebook stock at the IPO price of \$38—and time the market well—were able to flip their shares for a quick profit. Both with Facebook and more generally, these lucky investors are usually large institutional traders⁵ or select individual

1 Shayndi Raice et al., *Facebook Prices IPO at Record Value*, WALL ST. J., May 18, 2012, at B1.

2 David Weidner, *Facebook IPO Facts, Fiction and Flops*, WALL ST. J. (May 30, 2012, 7:29 PM), <http://www.wsj.com/news/articles/SB10001424052702304821304577436873952633672> [<http://perma.cc/RV4C-T8CD>]; see also Vindu Goel, *Facebook Shares Touch a Symbolic Threshold*, N.Y. TIMES, Aug. 1, 2013, at B1 (reporting that Facebook shares hit a low of \$17.55 in the months after the IPO, and did not return to the IPO price of \$38 until July 2013).

3 See, e.g., *EBC I, Inc. v. Goldman, Sachs & Co.*, 832 N.E.2d 26, 35 n.2 (N.Y. 2005) ("[T]he systematic underpricing of IPO shares is probably the most thoroughly documented empirical fact about IPOs."); Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 507 n.27 (1991) ("It has long been recognized in financial economics that IPO stocks are not only systematically more volatile than the market, but they are also systematically and substantially underpriced. No definitive explanation has been given for this phenomenon."). But see Jay R. Ritter, *The Long-Run Performance of Initial Public Offerings*, 46 J. FIN. 3, 3 (1991) ("[I]n the long run, [IPOs actually] appear to be overpriced."); Joseph A. Giannone, *Insight: Who Got Facebook IPO Shares? Fairness May Not Come into It*, REUTERS (May 18, 2012, 12:33 AM), <http://www.reuters.com/article/2012/05/18/net-us-facebook-ipo-smallinvestors-idUSBRE84G1E820120518> [<http://perma.cc/44M2-GE2G>] ("IPOs often offer an early pop, even if the shares stumble later . . .").

4 Mark Koba, *Facebook's IPO: What We Know Now*, CNBC (May 23, 2012, 7:11 PM), <http://www.cnbc.com/id/47043815> [<http://perma.cc/U3QH-LZER>].

5 See, e.g., ALAN D. MORRISON & WILLIAM J. WILHELM, JR., INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW 86 n.23 (2007) ("[I]nstitutional investors receive the majority of allocations in IPOs, and hence receive the largest share of the profits deriving from underpricing."); Reena Aggarwal et al., *Institutional Allocation in Initial Public Offerings: Empirical Evidence*, 57 J. FIN.

investors⁶ who have longstanding relationships with the investment banks that underwrite IPOs. Thus, although some individual—or retail—investors are able to acquire stock at the IPO price, most individual investors who want to acquire stock in newly public companies often need to purchase shares during secondary trading,⁷ leading some commentators to adopt critical views of the underwriting process.⁸ While this method of allocating IPO shares has existed for decades in the United States, heightened media coverage of Facebook's IPO coupled with significant losses for some retail investors—many of whom were uninformed and trading on nothing more than sentiment—brought the IPO machine under increased scrutiny.

For example, Khadeeja Safdar, writing for the *Atlantic*, revisited Facebook's IPO one year after its “disastrous debut” and reported that despite the losses incurred by many retail investors, “the preferred clients of big banks

1421, 1423 (2002) (finding that institutional investors, as opposed to average investors, “get a greater percentage of shares in IPOs with strong premarket demand”).

⁶ Fidelity, for example, requires individual investors to meet at least one of the following requirements to be eligible to participate in an IPO: (1) have either \$100,000 or \$500,000 in household assets (depending on the IPO), (2) execute at least thirty-six trades per year, or (3) be a “Premium or Private Client Group customer.” *How to Participate in an Initial Public Offering (IPO)*, FIDELITY, <https://www.fidelity.com/customer-service/how-to-participate-in-an-ipo> [<https://perma.cc/V656-359U>] (last visited Oct. 31, 2015); see also Giannone, *supra* note 3 (noting that “[t]hose with big brokerage accounts and a long history as customers of Wall Street firms likely got at least part of their orders for Facebook shares filled, but would-be buyers who had no such ties were lucky to get any”).

⁷ See, e.g., Susanne Craig & Evelyn M. Rusli, *Small Investors May Get to Own a Bit of Facebook*, N.Y. TIMES: DEALBOOK (May 3, 2012, 9:04 PM), <http://dealbook.nytimes.com/2012/05/03/small-investors-may-get-to-own-a-bit-of-facebook> [<http://perma.cc/9A5K-Y7UR>] (reporting before the Facebook IPO that, although the retail allotment could be as high as 20% to 25% of the offering, “[t]hose shares are highly coveted and typically go to the firm's top-producing brokers—and their best clients”); Telis Demos & Joe Light, *The New Wave of IPOs*, WALL ST. J. (July 12, 2013, 5:57 PM), <http://www.wsj.com/articles/SB10001424127887324694904578597592655184914> [<http://perma.cc/F3TJ-2A9U>] (reporting that although retail investors may receive 10% to 30% of an IPO, “the bulk of the shares go[] to a concentrated group of financial advisers who frequently participate in new offerings,” and those financial advisers generally “give preference to [clients] who generate more business or have expressed consistent interest in certain kinds of IPOs”); *id.* (recognizing that some IPOs “require minimum account sizes of as much as \$500,000”); Mark Elzweig, *Morgan Stanley's Facebook Curse*, REUTERS: THE GREAT DEBATE (May 10, 2012), <http://blogs.reuters.com/great-debate/2012/05/10/morgan-stanleys-facebook-curse> [<http://perma.cc/7BMG-2QE8>] (“It's always been the case that only a thin sliver of retail investors would be able to get hot IPO shares. They were typically high-net-worth clients who reliably invest in every single IPO that would come their way—hot or not. Shakier deals, of course, were always available to retail clients. . . . Over time, retail investors have been even less likely to win any meaningful amounts of shares in hot IPOs.”).

⁸ See, e.g., Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 713 (2005) [hereinafter Hurt, *Moral Hazard*] (“For every person inside the IPO loop who sold high, a retail investor bought high. What at first seems to be a very respectable process, . . . substantially conforming to existing securities laws, turns out to be a Wall Street-sponsored ‘pump-and-dump’ scheme.”).

walked away with huge profits.”⁹ These institutional and well-connected individual investors, who often possess superior knowledge—by virtue of their relationships with investment banks—than do most small investors, were able to do so by either taking a short position in Facebook stock (i.e., betting against the company), or selling the stock for a quick profit moments after acquiring it at the IPO price. Scott Sweet, a managing partner at an IPO research firm, recalled that one of his hedge fund clients sold the stock at \$42 and shorted it to make the hedge fund’s “largest profit of the year.”¹⁰ Sweet went on to say that it would be impossible for an ordinary investor to have access to the hedge fund’s superior information without having “a friend at a multi-billion dollar institution.”¹¹

While IPO underpricing is not a new phenomenon¹² and there are numerous theories that try to explain it,¹³ many commentators choose sides and suggest either (1) that the current system of allocating underpriced shares to favored institutional investors is not a problem, or (2) the opposite, that such allocation practices are unfair and an unbiased lottery system should be used instead. In this Comment, I posit that neither of these approaches is perfect because on the one hand, institutions play an essential role in the IPO process and must be enticed to continue their participation, while on the other hand, retail investors as a class are also an integral component of a stable market, and excluding the majority of individual investors from taking part in IPOs (or only allocating shares to them in overpriced IPOs) risks driving these investors away from the stock market altogether. Congressional and administrative agency action over the last century has attempted to shape the market into a domain that is fair for and accessible to all investors,¹⁴ and following this trend, additional measures should be considered to give retail investors access to hot IPO shares and ensure that the retail allotment offers at least a partially equitable distribution within the class, a reform that I suggest can be accomplished without upsetting the existing IPO framework.

⁹ Khadeeja Safdar, *Facebook, One Year Later: What Really Happened in the Biggest IPO Flop Ever*, ATLANTIC (May 20, 2013), <http://www.theatlantic.com/business/archive/2013/05/facebook-one-year-later-what-really-happened-in-the-biggest-ipo-flop-ever/275987> [<http://perma.cc/QYA6-A96Q>].

¹⁰ *Id.*

¹¹ *Id.*

¹² See Hurt, *Moral Hazard*, *supra* note 8, at 712 (noting that “large first-day returns of IPO shares have been reported for decades”). Not only has IPO underpricing been documented in the past, but it also continues to appear today, as seen with GoDaddy’s recent IPO on April 1, 2015, where shares climbed 30% above the IPO price within minutes of hitting the market. Michael J. de la Merced, *I.P.O. a Go*, N.Y. TIMES, Apr. 2, 2015, at B5.

¹³ See *infra* Section I.B (reviewing prominent IPO underpricing theories).

¹⁴ See *infra* Part II (discussing existing financial market regulations).

This Comment begins with a brief overview of the IPO process and an exploration of theories in the academic literature that offer varying explanations for IPO underpricing. In Part I, I also suggest that although there is a legitimate need for underpricing and book building, there is room for a small—but guaranteed—unbiased allocation of IPO shares to retail investors. In Part II, I review legislation, dating back to the Securities Act of 1933, that has attempted to increase disclosure of corporate financial information to investors. Despite the continued introduction of laws and regulations in this area, however, the controversy that followed Facebook’s IPO demonstrates that there continues to be a lack of transparency for the average individual investor who seeks to participate in the IPO process or understand the true value of a firm. In Part III, I propose that a small tranche of the shares of every IPO be distributed to retail investors through an unbiased lottery system. By adopting a statutory allocation of IPO shares for consumers, underwriters will be able to continue their relationships and information networks with institutional investors without excluding small individual investors from the process. I conclude by suggesting that a small but guaranteed allocation of IPO shares to retail investors, to be distributed through an impartial system, while certainly not solving all of the complex issues related to Facebook’s IPO, would nonetheless improve the public’s and the media’s perceptions of fairness in the market.

I. THE MECHANICS OF AN IPO

A. *Overview of the IPO Process*

When a company sells shares to the public for the first time, it generally hires an investment bank to underwrite its initial public offering.¹⁵ Other investment banks also participate in the IPO and form an “underwriting syndicate.”¹⁶ The IPO can be organized in a number of different ways. Two common structures are the “firm commitment” deal (where the underwriter guarantees that a minimum amount of money will be raised) and the “best efforts” arrangement (a deal with no financial guarantee).¹⁷

¹⁵ See *Credit Suisse Sec. (USA) LLC v. Billing*, 551 U.S. 264, 268-69 (2007) (describing typical underwriting practices during an IPO).

¹⁶ *Id.*

¹⁷ See *In re Kosmos Energy Ltd. Sec. Litig.*, 955 F. Supp. 2d 658, 670 n.14 (N.D. Tex. 2013) (“In a firm commitment underwriting, the issuer, or the company issuing the stock, sells all stock being issued to the underwriters, who then sell the stock to the public.”); see also *Cohen v. Stratosphere Corp.*, 115 F.3d 695, 697 n.1 (9th Cir. 1997) (“A best efforts offering requires the sales agent to use its best efforts to sell the securities, in contrast to a firm commitment offering, in which a brokerage

The lead underwriter prepares a registration statement, required by the U.S. Securities and Exchange Commission (SEC) as a prerequisite to offering shares to the public.¹⁸ The registration statement protects investors by mandating the disclosure of a significant amount of information about the issuing firm.¹⁹ Schedule A of the Securities Act lists broad disclosure requirements, ranging from basic biographical information about the company (e.g., names and addresses of directors and partners, as well as “the general character of the business”) to detailed financial statements, including a balance sheet and income statement.²⁰ As part of this process, the underwriter prepares a preliminary prospectus (or “red herring”²¹), which includes most of the information that will appear in the final registration statement, but not the offer price or the number of shares available.²² This material, along with other information related to the issuer, is available to the public online through the SEC’s EDGAR database.²³

With the preliminary prospectus in hand, the issuer and underwriter market the IPO at “road shows,” where presentations about the issuing firm are made to potential investors.²⁴ While road shows were exclusively conducted in person in the past, modern technology and new regulations have allowed

firm commits to purchase a certain number of securities, then attempts to resell them to the public.”).

¹⁸ *Credit Suisse*, 551 U.S. at 268.

¹⁹ See 15 U.S.C. § 77g (2012) (requiring the disclosure of specific information to investors prior to the issuance of securities, and giving the SEC broad rulemaking authority to ensure that the material includes “such other information, and . . . such other documents, as . . . [is] necessary or appropriate in the public interest or for the protection of investors”).

²⁰ *Id.* § 77aa.

²¹ A preliminary prospectus is called a “red herring” due to the cautionary disclaimer printed in red text on its cover page. *Café La France, Inc. v. Schneider Sec., Inc.*, 281 F. Supp. 2d 361, 366 (D.R.I. 2003).

²² See 17 C.F.R. § 230.430(a) (2015) (codifying the SEC’s rule that a preliminary prospectus is acceptable if it “contains substantially the information required by the Act and the rules and regulations thereunder . . . or contains substantially that information except for the omission of information with respect to the offering price . . . or other matters dependent upon the offering price”).

²³ “EDGAR” stands for “Electronic Data Gathering, Analysis, and Retrieval.” The SEC maintains the system “to increase the efficiency and fairness of the securities market for the benefit of investors, corporations, and the economy by accelerating the receipt, acceptance, dissemination, and analysis of time-sensitive corporate information filed with the agency.” *Important Information About EDGAR*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/edgar/aboutedgar.htm> [<http://perma.cc/68P8-VM2C>] (last modified Feb. 16, 2010).

²⁴ The SEC defines a road show as “an offer . . . that contains a presentation regarding an offering by one or more members of the issuer’s management . . . and includes discussion of one or more of the issuer, such management, and the securities being offered.” 17 C.F.R. § 230.433(h)(4) (2015); see also Securities Offering Reform, 70 Fed. Reg. 44,722, 44,753 (Aug. 3, 2005) (describing the purpose of a traditional road show).

road shows to be conducted electronically as well.²⁵ This, however, has raised new concerns about what constitutes a road show and whether average retail investors, who were often excluded from attending traditional in-person road shows,²⁶ should be able to access them.²⁷ If important information about the financial health of an issuing firm is revealed at a road show, it is important for all classes of investors to have some way of accessing it. While the SEC promulgated a rule called “Regulation FD” to ensure that all investors receive material information about a publicly traded company at the same time,²⁸ it has been suggested that “IPO issuers, like Facebook, are exempt from Regulation FD because the issuer is not yet a reporting issuer.”²⁹ In any event, the underwriter gauges demand for the IPO in response to the information received at the road shows, and adjusts the offer price accordingly.

If the issuing firm and the underwriter choose to use the traditional “book-building” process, then “[t]he underwriter prices the offering, herds investors and provides a sales force to issue the securities.”³⁰ Additionally, the underwriter “will learn, among other things, which investors might buy shares, in what quantities, at what prices, and for how long each is likely to hold purchased shares before selling them to others.”³¹ In the United States, most IPOs are marketed using the book-building process, and underwriters get “considerable latitude” in allocating shares using this method.³² In the final step before the IPO, the underwriter files a final registration statement

²⁵ See generally Securities Offering Reform, 70 Fed. Reg. at 44,725 (adopting various rules, to be codified at 17 C.F.R. pts. 200, 228, 229, 230, 239, 240, 243, 249, 273, that, “while limited in scope, properly address the areas that are in need of modernization” in the offering processes for regulated transactions).

²⁶ See, e.g., ARVIN GHOSH, PRICING AND PERFORMANCE OF INITIAL PUBLIC OFFERINGS IN THE UNITED STATES 24-25 (2006) (noting that classic road shows primarily target institutional investors); Christine Hurt, *Initial Public Offerings and the Failed Promise of Disintermediation*, 2 ENTREPRENEURIAL BUS. L.J. 703, 724 (2008) [hereinafter Hurt, *Failed Promise*] (“[T]he only investors invited to road shows are large, institutional investors and extremely wealthy individuals.”).

²⁷ After electronic road shows became permissible, websites popped up to make road show content available on the Internet. See, e.g., Thomas Kaplan, *Ex-Banker Brings Roadshows to the Masses*, N.Y. TIMES: DEALBOOK (Nov. 5, 2010, 2:45 PM), <http://dealbook.nytimes.com/2010/11/05/ex-banker-brings-roadshows-to-the-masses> [<http://perma.cc/3VHC-HLJX>] (reporting how a road show for the General Motors IPO in 2010 was streamed on RetailRoadshow.com).

²⁸ See *infra* notes 135-37 and accompanying text (explaining Regulation FD in more detail).

²⁹ Peter Cohan, *Do IPO Road Shows Violate Regulation FD?*, FORBES (May 4, 2012, 10:04 AM), <http://www.forbes.com/sites/petercohan/2012/05/04/do-ipo-road-shows-violate-regulation-fd> [<http://perma.cc/HZB7-TBJQ>].

³⁰ Anita Anand & Lewis Johnson, *Are Underwriters Essential? Empirical Evidence on Non Book-Built Offerings*, 3 N.Y.U. J.L. & BUS. 1, 1 (2006).

³¹ Credit Suisse Sec. (USA) LLC v. Billing, 551 U.S. 264, 269 (2007).

³² Aggarwal et al., *supra* note 5, at 1421.

with the SEC, which lists the offer price and the number of shares to be issued.³³ Shares are finally sold to the public on the IPO date.

Book building, however, is not the only way that IPOs are structured. Another method is the “Dutch auction,” in which any investor—without knowing what other investors are bidding—can bid for the issuing firm’s IPO shares.³⁴ Shares are then allocated to investors based on their bids, but each successful bidder pays the same price.³⁵ This procedure provides no special advantage to either retail or institutional investors: everyone has the same chance of purchasing IPO shares. Google famously used a modified Dutch auction for its IPO.³⁶

Below, I discuss how although the traditional book-building method marginalizes many retail investors, switching to a pure auction method is undesirable. Thus, the book-building approach should continue, but be supplemented with a small, mandatory allocation for equitable distribution among interested retail investors.

B. Underpricing Theories

Many IPOs appear to be underpriced.³⁷ While some consider underpricing essential to the investment banking business model,³⁸ others ask whether it is costly to the issuing firm, because the company is essentially leaving money on the table.³⁹ This Section will discuss a selection of academic theories that offer

³³ *Credit Suisse*, 551 U.S. at 269.

³⁴ See Anita Indira Anand, *Is the Dutch Auction IPO a Good Idea?*, 11 STAN. J.L. BUS. & FIN. 233, 234-37 (2006) (providing an overview of Dutch auctions).

³⁵ See *id.* at 234 (indicating that all shares are sold at the “clearing price”).

³⁶ Ari Weinberg, *IPO Dutch Auctions vs. Traditional Allocation*, FORBES (May 10, 2004, 3:00 PM), http://www.forbes.com/2004/05/10/cx_aw_0510mondaymatchup.html [<http://perma.cc/3R98-RRZD>].

³⁷ See, e.g., *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp. 2d 281, 300 (S.D.N.Y. 2003) (“For at least five decades, studies have shown that IPOs generally trade on the open market at a price significantly higher than the offering price, a phenomenon known as underpricing.”); Susanne Craig, *IPO Allotments: 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 heyday 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%.”). *But see* Ritter, *supra* note 3 (finding that many IPOs appear to be overpriced in the long run).

³⁸ See MORRISON & WILHELM, *supra* note 5, at 76 (“[I]f the investment bank wishes to maintain its network of investors, it will continue to underprice new issues.”).

³⁹ See Jay R. Ritter, *Money Left on the Table in IPOs by Firm* (Jan. 30, 2015) (unpublished manuscript), <http://bear.warrington.ufl.edu/ritter/Monnew.pdf> [<http://perma.cc/L5YD-SEL3>] (ranking companies in order of money “left on the table” in IPOs, “defined as the difference between the closing price on the first day of trading and the offer price, multiplied by the number of shares sold”). Because of that money left on the table, some scholars advocate for an alternative process. See, e.g., A. C. Pritchard, *Revisiting “Truth in Securities” Revisited: Abolishing IPOs and Harnessing Private Markets in the Public Good*, 36 SEATTLE U. L. REV. 999, 1015 (2013) (“Like wearing a fabulous gown

varying reasons for IPO underpricing and explain why, although underpricing appears necessary to compensate institutional investors for private information, allowing ordinary retail investors to participate as well may reduce criticism of current allocation practices.⁴⁰

1. The “Winner’s Curse”

One explanation for underpricing, first examined by Professor Kevin Rock, suggests that IPOs are intentionally underpriced to keep uninformed investors in the IPO market.⁴¹ This theory, later referred to as the “winner’s curse,” begins with the assumption that different classes of investors possess asymmetrical information.⁴² While uninformed investors subscribe to IPOs indiscriminately, informed investors leverage their superior knowledge to buy shares only when the IPO price is less than fair value.⁴³ Rock argued that, as a result, informed investors would crowd out uninformed investors when there is a high-quality IPO (i.e., when the IPO is underpriced), causing a winner’s curse in which uninformed investors receive shares at the IPO price only when the shares are sold above fair market value (i.e., when the IPO is overpriced).⁴⁴ Thus, all IPOs must be underpriced to compensate uninformed investors for this adverse selection problem and to keep uninformed investors active in the IPO market.⁴⁵

to a ball, newly public companies jostle for a bump in first-day trading in order to be noticed and attract trading volume. The media treat a sharp rise in the after-market price as a reflection of the offer’s ‘success,’ often ignoring the money the issuer has left on the table during the book-building process.”).

⁴⁰ The discussion that follows is not exhaustive. Numerous other explanations for underpricing have been provided, including some that suggest that underpricing is not intentional. For example, while an IPO firm’s stock price can rise on the open market, it may be prevented from dropping substantially in early trading due to underwriter price support and the “green shoe” (or overallocation) option, which can give an illusion of underpricing. See *In re Refco, Inc. Sec. Litig.*, 503 F. Supp. 2d 611, 646 (S.D.N.Y. 2007) (describing what happens when the “green shoe” option is exercised: “[I]n the event the IPO was oversubscribed, the underwriters would be authorized to sell more shares than originally provided for at the offering price”). See generally Judith S. Ruud, *Underwriter Price Support and the IPO Underpricing Puzzle*, 34 J. FIN. ECON. 135 (1993) (challenging the conclusion that positive initial returns come from deliberate systematic underpricing).

⁴¹ Kevin Rock, *Why New Issues Are Underpriced*, 15 J. FIN. ECON. 187, 188 (1986).

⁴² Kevin Keasey & Helen Short, *The Winner’s Curse Model of Underpricing: A Critical Assessment*, 23 ACCT. & BUS. RES. 74, 74 (1992).

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ See Rock, *supra* note 41, 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.”); see also *id.* at 188 (“[T]he equilibrium offer price includes a finite discount to attract uninformed investors.”).

Underpricing, however, only works as a solution to the winner's curse if both informed and uninformed investors actually get access to underpriced IPOs. But light regulation in the industry gives underwriters significant discretion during the allocation process.⁴⁶ Although Rock's theory and its assumptions have been subject to some criticism,⁴⁷ the losses suffered by many individual (and presumably relatively uninformed) investors after Facebook's IPO demonstrated how giving the underwriting syndicate complete autonomy in the allocation process can decrease ordinary investors' faith in the integrity of the market. This is troublesome given that the SEC has identified "investor confidence" as a key area of focus for the agency.⁴⁸ Former SEC Chair William Donaldson described "restor[ing] investors' faith and confidence in the fairness and integrity of our markets" as an "ongoing effort[.]"⁴⁹ This vision, coupled with the SEC's stance that market liquidity will decrease if investors doubt that the market is fair,⁵⁰ suggests that retail investors—as a class—should have access to IPOs. The SEC, however, currently advises the public that it "does not regulate the business decision of how IPO shares are allocated."⁵¹ The SEC also notes that "[m]ost underwriters target institutional or wealthy investors in IPO distributions," and further, in the case of "hot IPOs" (those where demand exceeds supply), "underwriters

⁴⁶ See James J. Park, *The Competing Paradigms of Securities Regulation*, 57 DUKE L.J. 625, 647-51 (2007) (describing how investment banks have significant latitude in allocating IPO shares as long as the banks do not use the process to bribe corporate executives for future business).

⁴⁷ See, e.g., Keasey & Short, *supra* note 42, at 78 (suggesting that IPOs are underpriced simply because "issuers are uncertain of the demand for IPOs and they underprice to ensure sufficient demand").

⁴⁸ See U.S. SEC. & EXCH. COMM'N, 2004-2009 STRATEGIC PLAN 10-12 (2004), <http://www.sec.gov/about/secstratplano409.pdf> [<http://perma.cc/VYW4-TEM4>] (including investor confidence as one of five important factors that affect the SEC's functioning).

⁴⁹ *Id.* at 11.

⁵⁰ See, e.g., Regulation NMS, 70 Fed. Reg. 37,496, 37,498 (June 29, 2005) (adopting regulations, to be codified at 17 C.F.R. pts. 200, 201, 230, 240, 242, 249, 270, to "give investors, particularly retail investors, greater confidence that they will be treated fairly when they participate in the equity markets" because "[m]aintaining investor confidence is an essential element of well-functioning equity markets"); Ownership Reports and Trading by Officers, Directors and Principal Security Holders, 67 Fed. Reg. 56,462, 56,466 (Sept. 3, 2002) (stating that an increase in market transparency "will likely enhance market efficiency and liquidity"); Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets*, 95 VA. L. REV. 1025, 1026 (2009) (noting that SEC documents are "filled with references to both the need to promote retail-level investor confidence to give depth and liquidity to the nation's financial markets and the desire to level the playing field between the meek and the privileged"); David S. Ruder, *Balancing Investor Protection with Capital Formation Needs After the SEC Chamber of Commerce Case*, 26 PACE L. REV. 39, 42 (2005) (observing that the SEC routinely conducts an analysis on the effect of new rules on the efficiency of the market).

⁵¹ *Initial Public Offerings: Why Individuals Have Difficulty Getting Shares*, U.S. SEC. & EXCHANGE COMMISSION, <http://www.sec.gov/answers/ipodiff.htm> [<http://perma.cc/Zz2QJ-LP35>] (last modified Nov. 24, 1999).

usually offer those shares to their most valued clients.”⁵² As a result, most individual investors face an extraordinarily difficult—if not impossible—challenge when attempting to subscribe to a coveted IPO.

This share allocation problem in the IPO market has been compared to Professor George Akerlof’s “lemon theory,” which offers an explanation for used car pricing.⁵³ Akerlof explained that in the used car market, a buyer knows that there is a chance that he will purchase a bad car (or a “lemon”), so he lowers his maximum offer price to hedge against this risk.⁵⁴ Akerlof elaborated on the broader application of his model, noting that “the difficulty of distinguishing good quality from bad is inherent in the business world; this may indeed explain many economic institutions and may in fact be one of the more important aspects of uncertainty.”⁵⁵ The typical retail investor seeking to subscribe to an IPO is comparable to a buyer in the used car market. Because the retail investor is aware that there is a chance that the IPO will be a loser, he lowers his maximum offer price. In the stock market, however, this discount may be insufficient because unlike in the used car market, where all buyers lack adequate information, in the stock market retail investors are uninformed relative to institutional investors.⁵⁶ As a result, “only uninformed investors will bid and lose money” on low-quality offerings.⁵⁷ “The losses are so great that the uninformed investors will eventually leave the I.P.O. market.”⁵⁸

2. Information Revelation

Underpricing has also been characterized as a necessary part of the investment banking business model insofar as it allows the underwriting syndicate to compensate institutional investors for the valuable information

⁵² *Id.*

⁵³ See, e.g., Steven Davidoff Solomon, *Why I.P.O.'s Get Underpriced*, N.Y. TIMES: DEALBOOK (May 27, 2011, 10:48 AM), <http://dealbook.nytimes.com/2011/05/27/why-i-p-o-s-get-underpriced> [<http://perma.cc/Q3RJ-3XUG>] (“The information asymmetry theory assumes that the I.P.O. pricing is a product of information disparities. . . . If you were an economics major, you might recognize this problem as a ‘lemon theory’—named after George Akerlof’s famous paper on how used cars are priced when information is uncertain.”).

⁵⁴ George A. Akerlof, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488, 489-91 (1970).

⁵⁵ *Id.* at 500.

⁵⁶ See, e.g., Jill E. Fisch, *Does Analyst Independence Sell Investors Short?*, 55 UCLA L. REV. 39, 39 (2007) (“The market for research has become increasingly segmented; institutional investors have access to highly sophisticated and costly information sources, while retail investors are receiving less information than ever.”).

⁵⁷ Solomon, *supra* note 53.

⁵⁸ *Id.*

that they provide during the road show process.⁵⁹ Like Rock's winner's curse model, this theory also deals with information asymmetry. Taking a different approach, Professors Lawrence Benveniste and Paul Spindt begin by recognizing that "issuers have an incentive to misrepresent themselves to potential investors as higher quality than they actually are."⁶⁰ Furthermore, investors may have nonpublic information about an issuer's competitors.⁶¹ Thus, "setting the sales price for an IPO is problematic; neither the issuing firm nor its underwriter can know precisely what the market's valuation of the stock will be."⁶² Because it is in investors' best interests to keep their superior information to themselves,⁶³ the underwriting syndicate must pay to obtain it, which the syndicate can do by allocating underpriced shares to the necessary investors.⁶⁴ There is also evidence that investment banks "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."⁶⁵

The information production theory thus proposes that underpricing IPO shares is a fundamental aspect of taking a company public. While some commentators have pointed out that underpricing results in the issuing firm leaving money on the table,⁶⁶ others have suggested that underpricing is merely a means of generating information that would otherwise incur a direct cost.⁶⁷

⁵⁹ See, e.g., MORRISON & WILHELM, *supra* note 5, at 76 ("If investment banks are to maintain their information network, they must sustain a reputation for paying for information."); Lawrence M. Benveniste & Paul A. Spindt, *How Investment Bankers Determine the Offer Price and Allocation of New Issues*, 24 J. FIN. ECON. 343, 344 (1989) ("IPO offer prices must be set low to provide profit to compensate investors for revealing positive information."); Alexander P. Ljungqvist & William J. Wilhelm Jr., *IPO Allocations: Discriminatory or Discretionary?*, 65 J. FIN. ECON. 167, 190-95 (2002) (finding that giving underwriters sufficient discretion to allocate underpriced IPO shares promotes valuable information production).

⁶⁰ Benveniste & Spindt, *supra* note 59, at 344.

⁶¹ *Id.*

⁶² *Id.*

⁶³ See *id.* ("[I]nvestors 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.")

⁶⁴ See MORRISON & WILHELM, *supra* note 5, at 76 (describing the costs of maintaining an information network).

⁶⁵ Kathleen Weiss Hanley, *The Underpricing of Initial Public Offerings and the Partial Adjustment Phenomenon*, 34 J. FIN. ECON. 231, 233 (1993).

⁶⁶ See, e.g., sources cited *supra* note 39.

⁶⁷ See Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. CHI. L. REV. 611, 631 n.27 (1985) ("Economists have asked whether the investment bankers of these firms are taking advantage of their clients to funnel gains to favored customers. It may be, though, that the apparent 'bargain' is nothing other than a substitute for additional expenses on investigating

Moreover, because companies considering going public are willing to pay a premium to work with an investment bank that has relationships with “skilled information producers,”⁶⁸ an investment bank’s reputation for pricing IPO shares effectively is incredibly important. Accordingly, I recognize that a primary purpose of underpricing may be to compensate certain institutional investors, but I propose below that providing an impartial selection of retail investors with a small allocation of underpriced offerings will reintroduce a sense of fairness into the system, even though these retail investors have not provided information to the underwriting syndicate.

3. Litigation Risk

Other commentators have suggested that underpricing can effectively serve as insurance against post-IPO litigation.⁶⁹ For example, under section 11 of the Securities Act of 1933,⁷⁰ investors can sue issuers and underwriters for losses that result from the issuer’s share price declining below the initial offer price due to omissions of material information in the prospectus.⁷¹ Therefore, in theory, issuers and underwriters can reduce the risk of litigation by either underpricing the shares (which reduces the risk of losses) or increasing disclosure (which reduces the likelihood of omissions).⁷² Some scholars, however, have questioned whether firms really choose to underprice their shares in lieu of disclosing all material information.⁷³ The mere threat of litigation may be sufficient to incentivize companies to truthfully disclose all information due to the potential “armies of plaintiffs’ attorneys sit[ting] on the sidelines—or more realistically in front of their computer terminals—waiting for the stock price of an IPO in aftermarket trading to drop.”⁷⁴ Despite this criticism, the litigation risk theory nonetheless supports the

and promoting the firm; it is a trade of (undisclosed) risk for extra expected return, and hence no special bargain.”).

⁶⁸ See MORRISON & WILHELM, *supra* note 5, at 77 (describing the features that issuers look for when selecting an investment bank).

⁶⁹ See Seha M. Tiniç, *Anatomy of Initial Public Offerings of Common Stock*, 43 J. FIN. 789, 818-19 (1988) (describing how IPO underpricing can act as insurance against liability).

⁷⁰ 15 U.S.C. § 77k (2012).

⁷¹ See Kathleen Weiss Hanley & Gerard Hoberg, *Litigation Risk, Strategic Disclosure and the Underpricing of Initial Public Offerings*, 103 J. FIN. ECON. 235, 235 (2012) (noting that “issuers and underwriters concerned about lawsuits can attempt to hedge litigation risk by underpricing”).

⁷² See *id.* at 236 (finding “strong support for a substitution of pricing for disclosure as a hedge against litigation risk”).

⁷³ See, e.g., Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for Its Future*, 51 DUKE L.J. 1397, 1446 (2002) (“[The] theory[] that IPO–underpricing is prompted by liability considerations[] has been largely discredited.” (footnote omitted)).

⁷⁴ James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. PA. L. REV. 903, 979 (1996).

argument that underpricing may be an essential part of successfully marketing an IPO, because even if issuers are confident that they have disclosed everything, plaintiffs' attorneys may still file frivolous lawsuits that impose economic costs on issuers and underwriters. By pricing the IPO conservatively, the likelihood of paying legal fees to defend against a (likely frivolous) lawsuit decreases.

4. Summary

Scholars have proposed and tested numerous hypotheses, a selection of which is highlighted above, in their quest to explain the well-documented phenomenon of IPO underpricing. Assuming that IPOs are deliberately underpriced, I consider the information revelation theory to offer one of the more compelling explanations for the trend. Without input from institutional investors, the underwriting syndicate would be forced to rely on the heavily biased information provided by the issuer,⁷⁵ and the book-building method of allocating IPO shares would collapse as prices would fail to reflect the shares' fair value. Since it is in each institutional investor's best interest to keep its valuable information to itself, it follows that the underwriting syndicate must compensate institutional investors for revealing this sensitive data. While other investment banking objectives, including mitigating the uninformed investor's winner's curse and hedging against litigation risk, are certainly advanced through underpricing, a primary purpose of underpricing seems to be to keep information flowing during the road show process.

II. EXISTING REGULATIONS

A. History

A significant amount of legislation has been enacted over the last century with the goal of adding stability, fairness, and transparency to the market.⁷⁶ The negative publicity following Facebook's IPO, however, suggests that the existing regulatory framework has failed to completely protect retail investors and provide them with equal access to the market.

The stock market crashed in 1929, and the Great Depression followed. Although a contributing factor to the crash was the practice of companies issuing stock along with questionable or fraudulent financial information, another problem involved the manipulation of the market by "some respected

⁷⁵ See Benveniste & Spindt, *supra* note 59, at 344.

⁷⁶ See *infra* notes 93–95 and accompanying text.

bankers . . . controll[ing] the market price of securities in which they held an interest by effecting huge purchases or sales as the situation required.”⁷⁷ These powerful investors did whatever was necessary to increase their profits: “When deceit was likely to be effective, they deceived; but when the truth was the best way to influence price, they told the truth.”⁷⁸ Congress responded by enacting the Securities Act of 1933 and the Securities Exchange Act of 1934.⁷⁹

B. *The Securities Act of 1933 and the Securities Exchange Act of 1934*

The Securities Act of 1933 was the first major federal law to regulate the sale of new securities.⁸⁰ It gave plaintiffs standing to sue for any false or misleading statement in a company’s registration statement.⁸¹ Congress’s primary goal was to protect investors by ensuring that the information that they used to execute trades was accurate.⁸² President Franklin D. Roosevelt stated that

⁷⁷ Steve Thel, *The Original Conception of Section 10(b) of the Securities Exchange Act*, 42 STAN. L. REV. 385, 412 (1990).

⁷⁸ *Id.* at 413.

⁷⁹ See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 194-95 (1976) (“Federal regulation of transactions in securities emerged as part of the aftermath of the market crash in 1929.”).

⁸⁰ Pub. L. No. 73-22, 48 Stat. 74 (codified as amended at 15 U.S.C. §§ 77a–77mm (2012)). IPOs were previously regulated primarily under state “blue sky” laws. “The name ‘blue sky’ derives from the practices of persons who were so fraudulent that it was stated that they would sell building lots in the blue sky in fee simple.” Charles G. Stinner, Note, *Estoppel and In Pari Delicto Defenses to Civil Blue Sky Law Actions*, 73 CORNELL L. REV. 448, 448 n.2 (1988).

⁸¹ See 15 U.S.C. § 77k(a) (2012) (allowing purchasers of securities to sue issuers and underwriters when “any part of the registration statement . . . contained an untrue statement of a material fact or omitted to state a material fact required to be stated therein or necessary to make the statements therein not misleading”); see also Herman & MacLean v. Huddleston, 459 U.S. 375, 381-82 (1983) (“Section 11 of the 1933 Act allows purchasers of a registered security to sue certain enumerated parties in a registered offering when false or misleading information is included in a registration statement. The section was designed to assure compliance with the disclosure provisions of the Act by imposing a stringent standard of liability on the parties who play a direct role in a registered offering.” (footnote omitted)).

⁸² See S. REP. NO. 73-47, at 1 (1933) (“The purpose of this bill is to protect the investing public and honest business. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation.”). *But see* Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1466 (1997) (arguing that pre-1933 corporate disclosure practices required for NYSE-listed companies were defensible and that the “evidence does not support the common claim that these requirements were ignored”); *id.* at 1468 (“[T]here is scant support for the idea that new-issue disclosure practices were substantially defective prior to 1933.”); Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L.J. 2359, 2372 (1998) (“[T]he historical ‘evidence’ of market abuses whose revelation congressional investigators orchestrated during the hearings preceding the creation of the federal regime as part of the New Deal agenda has been shown to be inaccurate.”); *cf.* George J. Benston, *Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange*

[t]here is . . . an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.

This proposal adds to the ancient rule of *caveat emptor*, the further doctrine “let the seller also beware.” It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.⁸³

Building on the foundation set forth in the Securities Act of 1933, Congress enacted the Securities Exchange Act of 1934 (Exchange Act) with the goal of regulating securities in the secondary market.⁸⁴ The Exchange Act requires all securities to be registered with the SEC, and its “antifraud provision,” under section 10(b), makes it “unlawful for any person . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device.”⁸⁵ The Exchange Act also gives the SEC the authority to prescribe additional rules “as necessary or appropriate in the public interest or for the protection of investors.”⁸⁶ This statutory grant of authority is sweeping: under the Exchange Act, the SEC has been described as having “an arsenal of flexible enforcement powers.”⁸⁷

But the public confidence emphasized by President Roosevelt has diminished in recent years.⁸⁸ This was illustrated by many retail investors’ experiences during Facebook’s IPO. “Wall Street blew it again,” wrote one commentator.⁸⁹ “They had this one grand chance in the Facebook IPO to try to restore some of the investor confidence that has been lost in the last four years of bank bailouts and bonuses—and they blew it.”⁹⁰ Some observers predicted this outcome. About two weeks before Facebook’s IPO, a *Bloomberg* reporter was skeptical of retail investors who sought to purchase shares at the IPO price:

Act of 1934, 63 AM. ECON. REV. 132, 133-34 (1973) (questioning whether the disclosures mandated by the Securities Exchange Act of 1934 have been beneficial).

⁸³ S. REP. NO. 73-47, at 6-7 (1933).

⁸⁴ Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C. §§ 78a-78pp (2012)).

⁸⁵ 15 U.S.C. § 78j(b) (2012).

⁸⁶ *Id.*

⁸⁷ Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

⁸⁸ See, e.g., Joseph Stiglitz, Opinion, *A Crisis of Confidence*, GUARDIAN (Oct. 22, 2008, 1:00 PM), <http://www.theguardian.com/commentisfree/cifamerica/2008/oct/22/economy-financial-crisis-regulation> [<http://perma.cc/SQK2-3Z7E>].

⁸⁹ Daniel Dicker, *Facebook IPO—How Wall Street Lost the Retail Investor, Again*, HUFFINGTON POST (July 28, 2012, 5:12 AM), http://www.huffingtonpost.com/daniel-dicker/facebook-retail-investors_b_1549602.html [<http://perma.cc/6CUG-3TWW>].

⁹⁰ *Id.*

Chances are slim that they'll be able to capture any of the gains that come on the first day of trading.

Only institutions with connections to the underwriters will get to buy at Facebook's offering price, which means most retail investors will miss the initial pop—typically where the bulk of the gains are concentrated.⁹¹

Although requiring a small slice of IPO shares to be distributed among retail investors would not ensure that every retail investor has access to each offering, it would allow a broader group of small investors to get the shares at the IPO price, and would further President Roosevelt's vision of reviving public confidence in the market. In light of the SEC's broad power to create rules in furtherance of "the public interest or for the protection of investors,"⁹² it is reasonable for the agency to use this authority to move some IPO shares into the hands of individual investors who lack close ties to financial institutions.

C. *Recent Amendments*

The Exchange Act has been amended numerous times since its enactment,⁹³ most recently by the Sarbanes–Oxley Act of 2002⁹⁴ and the Dodd–Frank Wall Street Reform and Consumer Protection Act.⁹⁵ The overarching theme in these amendments has been curtailing corrupt practices and ensuring that investors, particularly retail investors, are not deceived. For example, upon signing Sarbanes–Oxley into law, President George W. Bush echoed President Roosevelt's words, stating, "Today I sign the most far-reaching reforms of American business practices since the time of Franklin Delano Roosevelt. . . . This law says to shareholders that 'the financial information you receive from a company will be true and reliable, for those who

⁹¹ Ari Levy, *Facebook Retail Investors Seen Missing Day-One IPO Surge*, BLOOMBERG (May 8, 2012, 12:01 AM), <http://www.bloomberg.com/news/2012-05-08/facebook-s-retail-investors-seen-missing-day-one-ipo-surge-tech.html> [<http://perma.cc/XD2F-A6J7>].

⁹² 15 U.S.C. § 77g(a)(1) (2012).

⁹³ *See, e.g.*, Securities Litigation Uniform Standards Act of 1998, Pub. L. No. 105-353, 112 Stat. 3227 (requiring that securities class actions be brought in federal court); Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (imposing new rules on securities class action lawsuits and seeking to limit the abuse of class actions and the filing of frivolous lawsuits); Foreign Corrupt Practices Act of 1977, Pub. L. No. 95-213, 91 Stat. 1494 (forbidding the bribery of foreign officials); Williams Act, Pub. L. No. 90-439, 82 Stat. 454 (1968) (regulating required disclosures for corporations making tender offers).

⁹⁴ Pub. L. No. 107-204, 116 Stat. 745; *see also id.* § 302, at 777-78 (requiring the principal officers of publicly traded companies to personally certify the accuracy of released financial reports).

⁹⁵ *See* Pub. L. No. 111-203, 124 Stat. 1376 (2010) (implementing broad reforms to stabilize the market and increase transparency and accountability in the financial system).

deliberately sign their names to deception will be punished.”⁹⁶ Additionally, Dodd–Frank required the SEC to analyze investors’ financial literacy and, in response to the findings, develop programs to make improvements.⁹⁷ Dodd–Frank also called for the SEC to create an “Office of the Investor Advocate” to, among other tasks, “assist retail investors in resolving significant problems . . . [,] identify areas in which investors would benefit from changes in the regulations of the Commission . . . [, and] identify problems that investors have with financial service providers and investment products.”⁹⁸ Finally, shortly after taking office, SEC Chair Mary Jo White stated, “[T]he SEC strives each day to function as the investor’s advocate,” which includes adopting “new rules and regulations for the conduct of our markets.”⁹⁹ White went on to say that “[e]very member of the SEC’s talented and dedicated staff has a responsibility to the retail investor, and they take this responsibility very seriously.”¹⁰⁰ Despite these efforts, however, news reports continue to suggest that individual investors are being neglected by regulators.¹⁰¹

III. INCREASING ALLOCATIONS TO RETAIL INVESTORS AS A CLASS

A. Overview

Making a small percentage of shares from each IPO available to an unbiased selection of retail investors would reinforce the government’s goal of serving the entire community of investors. In a speech in 2010, then–SEC Chair Mary Schapiro emphasized that purchasers of stock in IPOs should “have confidence that they will be able to sell that stock at a fair and efficient price in the secondary market when they need or want to.”¹⁰² Schapiro continued,

⁹⁶ Remarks on Signing the Sarbanes–Oxley Act of 2002, 2 PUB. PAPERS 1319, 1319 (July 30, 2002).

⁹⁷ *E.g.*, STAFF OF THE U.S. SEC. & EXCH. COMM’N, STUDY REGARDING FINANCIAL LITERACY AMONG INVESTORS: AS REQUIRED BY SECTION 917 OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT (2012).

⁹⁸ 15 U.S.C. § 78d(g) (2012).

⁹⁹ Mary Jo White, Chair, U.S. Sec. & Exch. Comm’n, Protecting the Retail Investor, Speech at the Consumer Federation of America, 2014 Consumer Assembly (Mar. 21, 2014), <http://www.sec.gov/News/Speech/Detail/Speech/1370541226174> [<http://perma.cc/G62W-4PSY>].

¹⁰⁰ *Id.*

¹⁰¹ *See, e.g.*, Suzanne Barlyn, *The SEC’s New Investor Advocate Takes on Tough Assignment*, REUTERS (May 9, 2014, 8:08 AM), <http://www.reuters.com/article/2014/05/09/us-column-comply-sec-investors-idUSBREA480CR20140509> [<http://perma.cc/4E2M-LZ4N>] (noting that “[a] nearly four-year delay between Dodd-Frank’s 2010 enactment” and the appointment of a head of the Office of the Investor Advocate “is one indication how low investors rank”).

¹⁰² Mary L. Schapiro, Chairman, U.S. Sec. & Exch. Comm’n, Strengthening Our Equity Market Structure, Speech at the Economic Club of New York (Sept. 7, 2010), <http://www.sec.gov/news/speech/2010/spch090710mls.htm> [<http://perma.cc/WW5J-XKN5>].

“[I]f the equity market structure breaks down—if it fails to provide the necessary and expected fairness, stability, and efficiency—investors and companies pull back, raising costs and reducing growth.”¹⁰³ Thus, she concluded, “Ensuring the quality of equity market structure is an essential part of the SEC’s investor protection and capital formation mission.”¹⁰⁴

Although a guaranteed retail allocation would not result in all retail investors receiving hot IPO shares, it would allow some to participate. This would help mitigate the winner’s curse without curbing the underpricing that seems necessary to compensate institutional investors for information. There is also evidence that the book-building method, as opposed to an auction (which would presumably allow any number of retail investors to purchase IPO shares if they bid high enough), keeps the cost of capital low.¹⁰⁵ Thus, by continuing the book-building process, but simultaneously requiring that a small percentage of IPO shares be allocated impartially to retail investors, the cost of capital should remain low, the common complaints from small investors about unfairness should be addressed, and institutional investors would still be incentivized to reveal private information.

B. *The Dutch Auction Is Not a Desirable Solution*

Since traditional book building can result in accusations that IPO shares are unfairly allocated, it is tempting to consider using an unbiased Dutch auction instead. This approach, however, would not necessarily help individual investors and the market as a whole. On the recent tenth anniversary of Google’s Dutch auction IPO, a CNBC contributor questioned why we have not seen an increase in this type of deal structure over the last decade.¹⁰⁶ The contributor stated that Google sought to “[t]ake the short-term gains away from Wall Street and big money and give at least some ownership to the many consumers whose obsessive use of the search engine had allowed it to grow from a garage start-up into a multibillion-dollar phenomenon in half a decade.”¹⁰⁷ Despite this goal to fairly distribute IPO shares, the method has not taken off for several reasons. For example, the Dutch auction does not necessarily result in a fairer allocation of shares for retail investors, and it may even lead to

¹⁰³ *Id.*

¹⁰⁴ *Id.*

¹⁰⁵ See Ann E. Sherman, *IPOs and Long-Term Relationships: An Advantage of Book Building*, 13 REV. FIN. STUD. 697, 698 (2000) (arguing that despite “the popular sentiment that allocating shares only to regular investors prevents the general population from sharing in high returns,” the book-building method benefits society as a whole by reducing underpricing).

¹⁰⁶ Ari Levy, *Google Shares Took off, but the Auction Didn’t*, CNBC (Aug. 19, 2014, 12:00 AM), <http://www.cnbc.com/2014/08/19/es-took-off-but-the-auction-didnt.html> [<http://perma.cc/9ZNZ-3ALH>].

¹⁰⁷ *Id.*

inefficient capital markets.¹⁰⁸ Although the Dutch auction seems like the easiest way to give retail investors access to IPOs, it does not work effectively because many investors who rush to bid on the offering are uninformed and lack sufficient information to make bids.¹⁰⁹ This flood of unsophisticated bids not only makes it difficult to determine an issuing firm's fair market value, but also increases the "real risk of fraudulent issuers manufacturing their own demand and thus directly manipulating their own equity."¹¹⁰

Thus, while a Dutch auction may appear to solve the issue of unfair share allocation to retail investors, it may, in fact, raise the cost of capital. Admittedly, supplementing the traditional book-building method with a mandatory allocation to retail investors may introduce small inefficiencies as some uninformed retail investors get a windfall without contributing valuable information to the underwriting syndicate. The resulting long-term benefits of increasing the public's confidence in the fairness of the market, however, could help offset any small, short-term financial losses to institutional investors. Additionally, although small investors may indirectly benefit when institutions receive large allocations of underpriced shares,¹¹¹ direct small-investor participation in IPOs is also important because it will help encourage this group of investors to remain in the market, which in turn will promote liquidity and increase sources of capital.¹¹²

¹⁰⁸ See Anand, *supra* note 34, at 238-50.

¹⁰⁹ See Peter B. Oh, *The Dutch Auction Myth*, 42 WAKE FOREST L. REV. 853, 887 (2007) (finding that an auction results in "inaccurate pricing due to an influx of unsophisticated bids," causing "different problems that produce results quite comparable to and better justified by bookbuilding").

¹¹⁰ *Id.* at 908.

¹¹¹ This is a plausible argument because "[t]he universe of institutional investors includes mutual funds and ETFs . . . , as well as pension funds, insurance companies, and a wide variety of hedge funds and managed accounts." Luis A. Aguilar, Comm'r, U.S. Sec. & Exch. Comm'n, Institutional Investors: Power and Responsibility, Speech at Georgia State University (Apr. 19, 2013), <http://www.sec.gov/News/Speech/Detail/Speech/1365171515808> [<http://perma.cc/7CVR-J6MX>]. Since some retail investors have interests in some of these institutions, they potentially benefit when these institutions profit from large allocations of valuable IPO shares. These benefits, however, are difficult to reconcile with the higher prices that many individual investors pay for shares in newly public companies during secondary trading. See, e.g., Stephen J. Choi & A. C. Pritchard, *Should Issuers Be on the Hook for Laddering? An Empirical Analysis of the IPO Market Manipulation Litigation*, 73 U. CIN. L. REV. 179, 180 (2004) (describing how institutions "sell their overvalued stock to retail investors in the aftermarket" for a profit); Hurt, *Failed Promise*, *supra* note 26, at 724 ("Generally, institutional investors are the recipients of IPO shares at the offering price, and later sell their shares within days to retail investors at a higher price, pocketing the difference.").

¹¹² See *infra* notes 123-26 (discussing the benefits of retail investor participation in the stock market).

C. Comparison to Creditors in Bankruptcy

Professors Lucian Bebchuk and Jesse Fried argue that secured creditors in bankruptcy should give a slice of their security interests to unsecured creditors.¹¹³ This argument is comparable to the idea that an impartial selection of retail investors should receive an allocation of hot IPO shares, even though they do not provide information like institutional investors.

Under the “creditors’ bargain” theory of bankruptcy, the main objective of the bankruptcy process is to solve the collective action problem among creditors.¹¹⁴ In other words, while the bankruptcy system serves to avoid a race to the courthouse when the debtor is in financial distress, it should not otherwise alter state collection law.¹¹⁵ Accordingly, the Bankruptcy Code gives a secured creditor (i.e., one who has a security interest in the debtor’s assets) a secured claim in bankruptcy to the extent of the value of its collateral,¹¹⁶ while unsecured claims receive a pro rata distribution of unsecured assets.¹¹⁷

This fundamental principle, however, has been the subject of debate. Bebchuk and Fried argue that despite the widespread support for giving full priority to secured claims in bankruptcy, economic inefficiencies can actually be reduced by only partially prioritizing secured claims.¹¹⁸ This is because many creditors extend unsecured credit on fixed terms and do not, or cannot, adjust their claims when the debtor gives a security interest to a third party.¹¹⁹ The resulting subordination of unsecured creditors’ claims certainly transfers value to the secured creditor, but the cost imposed on the unsecured creditors

¹¹³ Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 859 (1996).

¹¹⁴ See, e.g., Barry E. Adler, *Bankruptcy and Risk Allocation*, 77 CORNELL L. REV. 439, 444 (1992) (“At its core, bankruptcy supplants debt collection remedies of individual creditors with a ‘collectivized debt collection device.’”); Kenneth Ayotte & David A. Skeel Jr, *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557, 1563 (2013) (“The Creditors’ Bargain theory is based on a collection of influential work that is most associated with Professors Douglas Baird and Thomas Jackson. This theory acknowledges the valuable role that corporate bankruptcy can play as a collective remedy for creditors.” (footnote omitted)).

¹¹⁵ See *Butner v. United States*, 440 U.S. 48, 55 (1979) (“Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding.”); see also Ayotte & Skeel, *supra* note 114, at 1564-65 (noting that “bankruptcy law is justified in altering the secured creditor’s procedural rights,” but “substantive rights in bankruptcy are defined by nonbankruptcy law except where bankruptcy law dictates otherwise”).

¹¹⁶ 11 U.S.C. § 506(a)(1) (2012).

¹¹⁷ *Id.* § 726(b).

¹¹⁸ Bebchuk & Fried, *supra* note 113, at 859.

¹¹⁹ See *id.* at 869-70 (explaining that “unsecured creditors that extend credit on fixed terms before a security interest is created simply do not have the opportunity to adjust these terms when the security interest is created”).

may outweigh the secured creditor's gain. As Bebchuk and Fried explain, "[A] borrower and a secured creditor may adopt a security interest that gives the two parties a larger slice of the pie at the expense of nonadjusting creditors even though the security interest at the same time reduces the size of the total pie."¹²⁰ In other words, a full-priority rule in bankruptcy can be inefficient because the costs associated with creating security interests reduce the total assets available to all of the parties.

Bebchuk and Fried find that "a mandatory partial-priority regime would be consistent with fundamental principles of contract law" and "would give the secured creditor the benefit of its bargain and not be unfair."¹²¹ They further reject the notion that the decision should be left to private ordering, arguing that "if a firm were given the choice between a full- and a partial-priority regime, it is unlikely that it would choose the partial-priority regime even if that regime were more efficient."¹²² In sum, the secured creditors should be required by law to carve out a slice of their collateral for unsecured creditors to avoid inefficient debt contracting.

Bebchuk and Fried's argument that there is too much protection for secured creditors is analogous to the dichotomy between institutional and most retail investors in the IPO market. Just as secured creditors in bankruptcy have information and negotiation advantages over unsecured creditors, institutional investors have significant power over small investors because of the institutions' connections to investment banks and extensive information resources. Like a partial-priority rule for secured creditors in bankruptcy, which could increase the efficiency of credit markets, a requirement that retail investors receive a minimum allotment of IPO shares—to be equitably distributed among the class—would be relatively easy to implement and help keep a greater number of individual investors active in the market.

Although Bebchuk and Fried were concerned about creditors who are incapable of adjusting, whereas individual investors can "adjust" in the sense that they could simply stop investing in the stock market, this is an undesirable outcome because retail investors are an integral component of the market. For example, scholars have noted that giving retail investors access to public markets contributes to market liquidity and, in turn, market efficiency.¹²³ Retail investors provide other benefits to financial markets as well, including a stable shareholder base for public corporations (because retail investors tend

¹²⁰ *Id.* at 896.

¹²¹ *Id.* at 866.

¹²² *Id.* at 930.

¹²³ See, e.g., Alicia Davis Evans, *A Requiem for the Retail Investor?*, 95 VA. L. REV. 1105, 1116 (2009) ("[L]iquidity, one element of a well-functioning market, is enhanced by the presence of individual investors.").

to trade less frequently than institutional investors) and a primary source of funding for small cap corporations.¹²⁴ SEC Commissioner Luis Aguilar summed up the importance of all investors—including retail investors—as follows:

[I]nvestors provide the capital that allows companies to grow and expand and to hire more workers. It is investors who are the real “job creators” in our economy. As such, it is in the country’s best interest that we ensure that there is an investment environment that works for investors, particularly the retail investors that live and work on Main Street.¹²⁵

Therefore, because “it is far from clear that the absence of retail investors would improve market efficiency,”¹²⁶ retail investors as a whole—not just a select few—should be able to participate in IPOs. Because excluding the majority of individual investors from IPOs is perceived as being unfair, it risks driving these traders out of the market in general, which could decrease liquidity in the long run. Like the absolute priority rule in bankruptcy, which increases the amount of pie received by secured creditors but decreases the overall size of the pie, giving nearly all underpriced IPO shares to well-connected investors certainly increases their wealth but may have deleterious effects over time as some retail investors grow increasingly frustrated and exit the market.

Bebchuk and Fried argue that, if given the option, a debtor would not adopt a partial-priority regime on its own because “involuntary creditors” (such as government agencies) often have large claims against the debtor in bankruptcy and these creditors would not respond by reducing the size of their claims even if they would be better off under the debtor’s partial-priority system.¹²⁷ For comparable reasons, leaving retail IPO allocations to the discretion of the underwriters and issuer places each investment bank in an uncomfortable situation. There would be a collective action problem, in that each bank in an underwriting syndicate, acting independently to advance its own interests, would be incentivized to allocate all of its shares to preferred clients, even though the industry as a whole could benefit from greater retail investor participation.¹²⁸

¹²⁴ See *id.* at 1117-18 (describing the benefits of retail investor participation in the stock market).

¹²⁵ Luis A. Aguilar, Comm’r, U.S. Sec. & Exch. Comm’n, Seeings Capital Markets Through Investor Eyes, Speech at Consumer Federation of America’s 26th Annual Conference (Dec. 5, 2013), <http://www.sec.gov/News/Speech/Detail/Speech/1370540451723> [<http://perma.cc/5P9F-LZ8Y>].

¹²⁶ Evans, *supra* note 123, at 1120. *But see* Langevoort, *supra* note 50, at 1064 (claiming that eliminating retail investors improves efficiency because retail investors tend to be “noise traders” who trade on rumors or trends rather than data).

¹²⁷ Bebhuk & Fried, *supra* note 113, at 930.

¹²⁸ This idea is analogous to ecologist Garret Hardin’s famous paper on the “tragedy of the commons,” in which Hardin argued that each individual is rewarded for acting to advance his own best interests, to the detriment of the community as a whole. See Garret Hardin, *The Tragedy of the*

Congress or the SEC would likely have to standardize the small investor allocation, but this change could be implemented without significant disruption to the book-building model.

D. Trend Toward Regulation

Interest in how IPO shares are allocated spiked when underpricing became increasingly prevalent following the dot-com bubble.¹²⁹ As early as 2000, a *Wall Street Journal* reporter found that although underwriters have broad discretion in how they allocate IPO shares, regulators had begun discussing the necessity of reforms.¹³⁰ A former SEC commissioner even commented that “[t]his looks like an area ripe for rule-making and [the SEC] should have done so years ago.”¹³¹

This is not to say that there has been no regulation in this area. For example, “spinning,” the practice of investment banks allocating valuable IPO shares to corporate executives, had become a popular way for banks to attract potential clients or continue existing relationships.¹³² In 2003, after a major investigation and enforcement action by the SEC and other regulators, ten major investment banks agreed to pay a total of \$875 million in penalties and disgorgement, in addition to entering into “a voluntary agreement restricting allocations of securities in hot IPOs—offerings that begin trading in the aftermarket at a premium—to certain company executive officers and

Commons, 162 SCIENCE 1243, 1244 (1968) (explaining how it is in each individual hunter’s best interest to capture as many animals as possible, despite the negative effects of such actions over time on society at large).

¹²⁹ In November 1998, an Internet company called TheGlobe.com priced its IPO shares at \$9 each. On the first day of trading, shares hit a high of \$97, giving an investor who received an allocation of shares at the IPO price and sold them at their first-day peak a return of nearly 1000%. Jeremy Kimball, *Assessing the Monetary Policy of Alan Greenspan’s Federal Reserve and Its Part in the Production of the Stock Market and Real Estate Bubbles*, 5 N.Y.U. J.L. & BUS. 937, 937 (2009) (reviewing WILLIAM A. FLECKENSTEIN & FREDERICK SHEEHAN, GREENSPAN’S BUBBLES: THE AGE OF IGNORANCE AT THE FEDERAL RESERVE (2008)).

¹³⁰ Charles Gasparino et al., *SEC Targets IPO Process with Probes—Latest Case Poses Challenge for Agency, but Solutions Exist*, WALL ST. J., Dec. 19, 2000, at C1.

¹³¹ *Id.* (alteration in original).

¹³² See, e.g., *In re eBay, Inc. S’holders Litig.*, No. C.A. 19988-NC, 2004 WL 253521, at *1 (Del. Ch. Feb. 11, 2004) (discussing how an investment bank attempted to win eBay’s future business by bribing its executives with IPO shares from other firms that they could flip for “instant profit by selling the equities in a few days or even in a few hours after they were initially purchased”); Sean J. Griffith, *Spinning and Underpricing: A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings*, 69 BROOK. L. REV. 583, 586 (2004) (“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.”).

directors, a practice known as ‘spinning.’¹³³ The SEC noted that the settlement would “*promote fairness in the allocation of IPO shares* and prevent firms from using these shares to attract investment banking business.”¹³⁴ The SEC’s recent attention toward IPO allocations, coupled with Facebook’s problematic IPO, suggests that reform may be on the way absent a change in allocation practices.

Another SEC rule, titled Regulation Fair Disclosure (Regulation FD), dealt with the practice of issuers disclosing material nonpublic information to only certain classes of investors, particularly large institutional investors.¹³⁵ Heeding Congress’s warning that “the small investor will be—and has been—reluctant to invest in the market if he feels it is rigged against him,”¹³⁶ the SEC prohibited selective disclosure with Regulation FD. Requiring small investors to receive a narrow allocation of IPO shares would further Regulation FD’s intent because, given how strongly underwriters usually prefer regular clients, if there is a future IPO where small investors are preferred in excess of the mandatory allocation, it would raise red flags that well-connected investors possess superior information. In fact, after Facebook’s IPO, it was revealed that individual investors received an unusually high allocation of shares,¹³⁷ perhaps because institutions and certain other investors received negative information about the company.

E. *Providing Small Investors with Access to IPO Shares*

If the proposal discussed in this Comment were adopted, Congress or the SEC would need to determine an appropriate percentage of shares from each IPO to set aside for distribution to retail investors. Although the specific percentage of shares that is designated for these investors may appear to be a relatively arbitrary figure, Congress has managed similar issues in the past. For

¹³³ Press Release, U.S. Sec. & Exch. Comm’n et al., Ten of Nation’s Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking (Apr. 28, 2003), <http://www.sec.gov/news/press/2003-54.htm> [<http://perma.cc/Y89F-B9XJ>].

¹³⁴ *Id.* (emphasis added).

¹³⁵ Regulation FD, 17 C.F.R. § 243.100-.103 (2015). *But see* Cohan, *supra* note 29 (questioning whether Regulation FD applies to IPO issuers).

¹³⁶ H.R. REP. NO. 100-910, at 8 (1988).

¹³⁷ See, e.g., Jacob Bunge et al., *Investors Pummel Facebook*, WALL ST. J. (May 22, 2012, 2:09 PM), <http://www.wsj.com/articles/SB10001424052702303610504577417911775222058> [<http://perma.cc/FA6P-E4XC>] (“Retail, or individual, investors usually are allocated up to 20% of the total shares allotted in an IPO, but in Facebook’s case, retail allocation was around 25%”); Adam Shell, *Facebook IPO: Cautionary Tale for Individual Investors*, USA TODAY (June 1, 2012, 11:02 AM), <http://usatoday30.usatoday.com/money/perfi/stocks/story/2012-05-31/facebook-ipo-investors/55319086/1> [<http://perma.cc/67A9-LMT7>] (reporting that retail investors “were allotted an unprecedented 25% of Facebook IPO shares” and “found themselves on the losing side of a Wall-Street-hyped investment gone bad”).

example, section 16(b) of the Exchange Act prevents corporate insiders from short-swing trading.¹³⁸ This is accomplished by preventing any “person who is directly or indirectly the beneficial owner of more than 10 percent of any class of any equity security” from profiting from the sale of such security within six months of its purchase.¹³⁹ The SEC has also used seemingly arbitrary thresholds in its reporting requirements for the acquisition of securities; for example, the SEC mandates that an investor file a Schedule 13D when acquiring beneficial ownership of more than five percent of certain classes of stock.¹⁴⁰ Therefore, the fact that the percentage of shares required to be allocated to ordinary individual investors may on its face appear to be arbitrary is not an insurmountable obstacle.

If the class of retail investors is granted a minimum allocation of IPO shares for impartial distribution, it will be necessary to adopt a fair method of distributing shares among the competing individuals. There are at least three possible approaches: (1) first-come, first-served, (2) pro rata distribution, or (3) a lottery system. I would suggest divvying up the retail investor allotment through a slightly modified lottery that satisfies randomly selected retail investors’ orders, but only up to a maximum number of shares per individual. In other words, once all interested individual investors have submitted orders for a specific number of shares by an established deadline, the underwriting syndicate should fill the orders (with each order capped at, for example, one hundred shares per investor) in random order until the retail allotment is exhausted. The cap per investor would certainly fluctuate based on the number of shares being offered by the issuer. This approach is preferable to a first-come, first-served system because the latter would pressure investors into placing orders before they have time to thoroughly weigh the pros and cons of an offering. A lottery is also a better solution than a pro rata distribution that gives a proportional allocation to each investor who signs up, because although a pro rata system would ensure that each retail investor gets a piece of the allocation, it would likely be an extremely small stake in many IPOs. A lottery system with a cap is also superior to a pure lottery because a pure lottery would increase the chances of larger retail investors obtaining most of the shares. Therefore, any required allocation of IPO shares to retail investors should be sold to individuals through the use of a modified lottery.

138 See Timothy Tomlinson, *Section 16(b): A Single Analysis of Purchases and Sales—Merging the Objective and Pragmatic Analyses*, 1981 DUKE L.J. 941, 958 (“Section 16(b) is designed to prevent short-swing trading by persons with a particular relationship to the issuer . . .”).

139 15 U.S.C. § 78p(a)(1), (b) (2012).

140 17 C.F.R. § 240.13d-1(a) (2015).

CONCLUSION

Facebook's high-profile IPO brought headlines that small investors suffered losses because of a combination of inferior information and unfair allocation practices. By adopting a required allocation and fair distribution of IPO shares to retail investors, underpricing—which seems to be a necessary part of book building—would be permitted to continue without totally excluding individual investors. The proposal in this Comment aligns closely with the legislative intent of laws enacted over the last century because it would increase the fairness of the market and promote efficiency by allowing for broader retail investor participation. Ensuring that a tranche of IPO shares is equitably distributed among retail investors would be relatively easy to implement and address a common criticism of the book-building process.