The Hot IPO Phenomenon and the Great Internet Bust

Andres Rueda

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ARTICLES

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I. INTRODUCTION

It is impossible to adequately portray today's economy without devoting time to the Internet startups that drove the stock market's meteoric rise in the last decade. Truly, an immense amount of wealth was transferred during the Internet boom — the tech-heavy Nasdaq 100 rose by 274% during 1998 - 1999, while the broader Nasdaq Composite Index rose by more than 500% between 1995 - 1999. Unfortunately, between June 2000 and June 2001, an astounding $4 trillion in wealth evaporated from those unlucky investors who bought into what would soon be recognized as one of the most remarkable speculative bubbles in recent memory. Indeed, the federal government has begun a broad inquiry into this matter, because something doesn't smell quite right.

* Cornell, B.A., Georgetown, J.D., L.L.M. I would like to dedicate this article to my wife Enikö Hangay, for her love, patience, and support. Additionally, I would like to give special thanks to Vadim Daynovsky and Dwayne Mason for their editorial input.


3. See Susan Pulliam & Randall Smith, SEC's IPO Inquiries Advance on Two Fronts, WALL ST. J., Nov. 28, 2001, at C1 (describing a continuing SEC probe into certain investment bank practices, namely "whether [Wall] Street
What explanation could account for such a stark reversal of fortune for the average investor? In part, blame should be placed upon those investment banks and financial advisors that managed and distributed new startup securities. This Article explores the legal aspects of the initial public offering ("IPO") process and explains how its mechanics played a significant role in priming the Internet boom and its eventual implosion.

At the heart of the Internet boom was the public's insatiable appetite for Internet-related IPOs. In August 1995, the beginning of the Internet boom was marked by the IPO of Netscape Inc., the leading Internet browser company at the time. The market greeted Netscape's IPO with explosive enthusiasm, even though Microsoft Corporation was seeking to distribute its rival Internet browser for free, as part of Windows 95. Moreover, Netscape had never turned a profit, having lost $13 million since its founding in 1994. Nonetheless, the day before the offering, the underwriters increased the number of shares in the offering from 3.5 million to 5 million and doubled its price to $28 per share. Demand was so intense that during the first hour of trading, Netscape's shares still

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4. In the securities industry Initial Public Offering refers to the first offering of an issuer's equity securities to the public through a registration statement. See BLACK'S LAW DICTIONARY vii-x (6th ed. 1991).

5. See Elstrom, supra note 2, at EB16.


7. See Molly Baker, Netscape's IPO Gets an Explosive Welcome, WALL ST. J., Aug. 9, 1995, at C1 (noting that already, according to Wall Street experts, "investors have placed orders for an astounding 100 million shares.").

8. See id.

managed to shoot up from $28 to $75, an increase of 168%. "After the first day of trading, Netscape [was] worth $2.2 billion." As testament to Netscape's phenomenal market valuation, in 1999 America Online ("AOL") purchased it for an astonishing $10 billion.

Hot IPOs were a pervasive phenomenon during the Internet boom. In 1998 and 1999, the value of IPO shares frequently surged 400 - 500% during the first day of trading. To illustrate, on November 12, 1998, shares of the now defunct TheGlobe.com, a website founded by two Cornell University undergraduates, soared 606% during morning trading, from $9 to $48. A company with no clear business plan, which gave out "web space" for free, thereby attained a market valuation of $1.5 billion.

During the Internet boom, parties other than the offering company were profiting substantially from public offerings of securities, often reaping more money than was raised during the IPO. First-day price run-ups of the magnitude observed during the Internet boom suggest two immediate questions. First, were underwriters purposefully under-pricing IPO shares? Second, were the underwriters channeling the shares to favored clients in order

11. Yoffie & Cusumano, supra note 9, at 24.
12. See id. at 8.
13. When there is substantial market interest in an IPO, it is said to be “hot.” Typically, a hot IPO will be priced so that it “pops,” or experiences a sudden surge, during the first day of trading. See generally, Richard A. Booth, Discounts and other Mysteries of Corporate Finance, 79 CAL. L. REV. 1055, 1093 (1991). Netscape’s IPO was one such “hot” IPO.
16. Id. At one point, stocks for the company reached a price of $97, giving the company a market valuation of $2.9 billion. See Erin Ferrell, The Sun Sets on TheGlobe.com, DAILY DEAL, Aug. 3, 2001. Another example involves VA Linux Systems, a distributor of computer operating systems software - its shares shot up to just a shade under 700% over its initial offering price in December of 1999. See Coffee, The IPO Allocation Probe: Who is the Victim?, supra note 14, at 5.
to preserve goodwill and profit from a continued business relationship?

Resolution of the latter question is particularly significant given how Wall Street makes its money. Investment bankers have earned $2.1 billion in underwriting fees from Internet-related issues since 1997. That figure, although significant, pales in comparison to the amount that the industry earns in trading fees, which accounted for an estimated forty percent of Wall Street's profits during 2000.

Trading is undoubtedly a high-margin business that investment banks have zealously sought to preserve. Investment bankers charge mutual funds about five cents per share traded, three cents of which represents pure profit to the bank. By contrast, electronic communications networks such as Instinet and Archipelago can presently execute the same trades at less than a penny per stock. Despite this new technology, "from 1998 to 1999, [investment bank] revenues from spreads and commissions climbed from $44 billion to $66 billion — a 50% jump."

Investment banks can exploit their underwriting activities to increase those all-important trading revenues; this is done by "creating a market" in the stock offered during an IPO. As a practical matter, an investment bank will have a near-monopoly in aftermarket trades for the first few weeks following an IPO, a period during which the stock has not yet been disseminated widely enough to allow other banks to freely offer it to their customers. This ephemeral period allows the investment bank to

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17. See Elstrom, supra note 2, at EB16.
19. See id.
20. See Tully, Betrayal on Wall Street, supra note 18 ("Institutions can now trade at less than a penny a share on ECNs.").
21. See id.
22. Id.
23. See id. at 86 (pointing out that, "[a]s a rule, the lead underwriter on each deal gets a near-monopoly on trading for the first week or two, because the grateful funds sell their shares back to Merrill, Lehman, or whoever managed the offering.").
make large profits on the purchases and sales of that stock – it can generate "fat" spreads that significantly boost up trading revenues.

However, IPOs may serve to increase trading profits in a more insidious way. During 1999 - 2000, all underwriting activities combined brought Wall Street $7.3 billion in revenues. Notably, during the same period Wall Street’s favorite clients (i.e., those capable of trading large blocks of stock and thereby generating sizeable commissions) reaped $66 billion in instant profits from IPO under-pricing. Did investment bankers use IPO allocations as commercial bribes to mutual funds and other institutional investors in order to maintain or enhance lucrative trading revenues?

Because hot IPOs provided access to practically "guaranteed profit[s]," during the Internet boom they became a "kind of currency readily used by brokers, underwriters, and issuers to reward good customers." Investment bankers, with the complicity of mutual funds and other institutional investors, used their access to hot IPOs to bolster other profitable aspects of their business. Meanwhile, issuers were left holding the bag. One prominent securities lawyer asked, "[h]as our system for capital raising for young companies become dysfunctional when as much as 75 percent of the market value of the stock sold in the IPO, as of the end of the first trading day, goes to two classes of financial intermediaries – namely, underwriters and institutional

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24. See id. ("[B]y generating those fat spreads buying and selling new IPO shares, firms match or exceed the underwriting fees in trading profits.").
26. See id.
28. See Zweig & Spiro, supra note 27; see also Michael Siconolfi, Venture Capitalists Get Stern Warning on 'Spinning' IPOs, WALL ST. J., Nov. 17, 1997, at C16.
investors?" 29

Issuers were not the only victims of the hot IPO phenomenon during the Internet boom. Small investors bore the brunt of the losses suffered in the aftermath of the collapse of the market for Internet stocks, as they could not compete on a level playing field with mutual funds and other institutional investors. Those institutional investors that did not immediately cash in on hot Internet IPOs gradually thinned their Internet holdings before the market imploded. 30 But small investors, instead of "flipping" Internet stocks for a quick gain, held on to them, expecting a long-term gain that would never materialize. The result was disastrous, and the aftermath continues to exact its toll. 31

The magnitude of the losses that small or so-called "retail" investors suffered during the Internet boom is a politically explosive issue for the securities industry, and may cause fundamental changes in the way the industry does business. 32 Congressional hearings have been held to narrowly examine the


30. See Noelle Knox et al., Officials Suspect Manipulation; Agencies Scrutinize Some Investment Banks' Activities, USA TODAY, May 25, 2001, at 1B. In contrast, by May 2001, "individual investors owned as much as 75% of the shares in Internet companies, compared with about 44% of the shares in General Motors." Id.

31. Flipping is the practice of buying hot IPO shares at the offering price and quickly reselling them in the aftermarket, thus reaping an immediate profit when IPO shares climb in value right after their initial release. See, e.g., Jonathan A. Shayne & Larry D. Soderquist, Inefficiency in the Market for Initial Public Offerings, 48 VAND. L. REV. 965, 976 (1995).

32. "Of the 367 Internet outfits taken public since 1997 that... [were still trading by April 2001], 316 [were trading] below their offering prices." Elstrom, supra note 2, at EB16. Indeed, by June 2001, only 27% of websites were profitable. See Katherine Hobson, Bucking the E-Biz Trend, U.S. NEWS & WORLD REP., June 4, 2001, at 36. Currently, most online retailers continue to lose money, at an average of 13% of sales. Id.

33. See Shawn Tully, Is Wall Street Serious About Reform?; Slammed by the Public, the Press, and Now Even Congress, the Big Investment Firms Have Promised to Change the Way They do Business; Their Lobbying Efforts Tell a Different Story, FORTUNE, July 9, 2001, at 90 ("[I]f Congress and the SEC hang tough, they could encourage a new breed of analysts proffering unbiased research.").
role of analysts, who would whip up the buying frenzy needed to create hot IPOs, with the use of “folksy” and completely unrealistic forecasts. The media has also been unsparing in its criticism of the industry.

In 1997, Chairman of the National Venture Capital Association, Carl Thoma, warned the Association’s members against abusing the IPO process for private gain. He stated, “[t]imes are good. Let’s not all get greedy, and remember that an ounce of prevention is worth a pound of cure.” The advice was farsighted. Now that the Internet boom has turned sour, aggrieved investors are turning with anger to the financial firms that churned the Internet frenzy, and “lawsuits are piling up faster than dead dotcoms.”

Presently, at least three government agencies are involved in determining the complicated money flow, and whether any laws were broken. The Attorney General for the State of New York, for example, is investigating brokerage firms’ research and stock recommendation policies to public customers. The Securities and Exchange Commission (“SEC”) and the National Association of Securities Dealers (“NASD”) are investigating the liability of venture capitalists, institutional investors and other big Wall Street players that “flipped” hot IPOs for risk-free profits. The SEC is

34. See id.
35. See id.
36. Siconolfi, supra note 28, at C16.
37. Daniel Kadlec, Wall Street’s New Honor Code; Analysts Got Rich Promoting Bubble Stocks and IPOs; Now They Say They’ll Come Clean; Whom Are They Kidding?, TIME, June 25, 2001, at 73; see also Daniel Kadlec, Investigate The Investors; Congress and the Courts Are Probing Analysts’ Conflicts, but Investors’ Bubble Behavior Was Loathsome Too, TIME, Aug. 13, 2001, at 68; Matthew Lynn, Come the Retribution, SUNDAY BUS., Aug. 12, 2001, at 19. See, e.g., In re Initial Public Offering Antitrust Litig., No. 01 Civ. 2014 (S.D.N.Y. filed Jan. 2, 2002) (providing an example of a recent class action complaint filed against underwriters of IPOs during the Internet boom).
38. See Kadlec, supra note 37, at 73.
especially interested in Wall Street’s methods of IPO share allocation during the particularly bullish 1999-2000 period.41

This Article investigates the legal issues surrounding the securities industry’s behavior during the Internet boom. Understanding exactly how IPOs are put together is key to the legal analysis, and accordingly, Part I will provide an overview of the underwriting process and market mechanisms that allow underwriters to pull IPOs virtually out of thin air.

The role of analysts in triggering the speculative frenzy that led to the Internet boom has been the subject of intense debate. Part II will examine the conflicts of interest affecting analysts who work for investment banks that actively underwrite new issues. In particular, this Article will examine how investment banks can exploit their analysts’ ability to move the market in order to generate hot IPOs. The Article will also pay particularly close attention to Regulation FD, which was passed with the intention of breaking the “chummy” relationship between analysts and corporate insiders that characterized the late 1990’s.

Part III of the Article will examine the NASD rules governing the allocation of hot IPOs. The currently applicable Free-Riding and Withholding Interpretation will be discussed, as well as proposed Rule 2790, which will supersede the Free-Riding and Withholding Interpretation once the NASD adopts it. The Article will then examine institutional investors’ alleged use of kickbacks in the form of increased trading volume or trading commissions to induce underwriters to facilitate access to hot IPOs. The Article will discuss several legal theories that could be used to criminalize such behavior.

In Part IV, the Article will turn to the legal standards that

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Imagine you are a banker taking technology companies public in 1999, the height of the IPO craze.

You make millions of dollars for yourself and your firm. But what if you could find a way to make even more millions by tapping into the seemingly endless demand for hot new technology IPOs? Say you offered fund managers an extra helping of those highly desirable IPO shares. The catch, well, they’d just have to pay a little extra on subsequent trades. Very tempting. And quite illegal. But that’s exactly the scenario at the heart of a federal government probe into large investment bank’s allotment practices.

Id. 41. See Chaffin & Hill, supra note 39, at 28.
prevent mutual fund managers and other investment advisers from pocketing hot IPOs. Specifically, the SEC’s approach to the Monetta Financial Services precedent will be highlighted.

This Article argues that the current legal and regulatory infrastructure is insufficient to address the hot IPO phenomenon, and proposes certain reforms to prevent its recurrence. In particular, analysts should be required to indicate any bias or conflict of interest to potential investors. Most importantly, the NASD or SEC should eliminate favoritism in the IPO allocation process by mandating the use of equitable mechanisms to conduct distributions.

II. HOT IPOS AND THE UNDERWRITING PROCESS

The IPO process involves five distinct steps. An issuer of stock must generally coordinate efforts with one or more underwriters. Therefore, the first step of the IPO process involves selecting an underwriter or underwriting team and negotiating an underwriting agreement, which usually takes between one and two months.

Second, a prospectus must be drafted and the offering must be registered with the SEC. This process usually takes two or three months.

Next, the underwriter stages a “road show” to introduce the issuer’s product and its management team to institutional and other qualified investors who may be interested in purchasing large blocks of shares. Road shows usually last two to four weeks,
although more time may be required if the underwriter wants to generate interest in the offering from investors located abroad.\textsuperscript{48}

Once the SEC authorizes the offering, the underwriter determines a final price for the offering. This price is based on prior negotiations with the issuer and the success of the road show.\textsuperscript{49} Trading usually begins within twenty-four hours of price determination.\textsuperscript{50}

The final phase of an offering involves the "lock-up period," which usually lasts 180 days.\textsuperscript{51} During the lock-up period, certain investors are prohibited from selling their stock in the open market in order to prevent a potential run on the stock and a destabilization of its price.\textsuperscript{52}

Commentators have described the IPO frenzy of the Internet boom as a con game and a virtual "license to print money." Many investment bankers and their institutional clients got rich, while issuers companies and individual investors got the short end of the stick.\textsuperscript{53} A basic knowledge of the underwriting process and its regulatory framework is important to understanding how IPOs may have been abused by the investment banking industry. Accordingly, the next section will discuss in greater detail the five steps of the IPO process.

\textbf{A. Selecting the Underwriting Team}

Preparing an IPO for public distribution requires substantial planning. Issues regarding executive compensation, corporate

\textit{Liability for Oral Statements Made at Road Shows}, 23 \textit{Iowa J. Corp. L.} 541, 548-49.

\textsuperscript{48} Hovarth, \textit{supra} note 43, at 6.

\textsuperscript{49} See \textit{id.} ("It is imperative that managers have at least preliminary valuation discussions with the underwriters vying to do their IPO, because choosing an underwriter with a strong difference of opinion on the company's valuation could spell disaster.").

\textsuperscript{50} See \textit{id}.

\textsuperscript{51} \textit{Id}.

\textsuperscript{52} \textit{Id}.

\textsuperscript{53} See Tully, \textit{Betrayal on Wall Street}, \textit{supra} note 18 (detailing how most issuers received less from their IPO than they should have, objectively); see also Noelle Knox et al., \textit{supra} note 30 (discussing a lawsuit alleging that average investors were conned by big investment banks).
structure and organization, as well as corporate charter and bylaws must be addressed. When coordinating the IPO, the underwriter, its legal counsel and experienced auditors and accountants should work side by side with the issuer's management.

Typically, issuers prefer to hire prestigious investment banks with solid connections to institutional investors, a good understanding of the issuer's business, and which will continue to track the issuer and maintain a market interest in the stock following the IPO. Investment bankers normally receive a percentage of the funds that the issuer raises through the IPO. In fact, under the cartel-like price structure that prevailed among the half-dozen or so market players that dominated investment banking during the Internet boom, the usual fee was a flat, non-negotiable seven percent underwriter's discount. That is substantially more than the 3.4% charged by Japanese banks at the time, and 5% charged by European banks. Accordingly, investment bankers earned approximately $8 billion in fees, out of

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54. See Boyce, supra note 47, at 5.
55. See id.
56. See Debora Vrana, Bitter Lessons for Wall St.'s 'Orphans'; More Companies Are Rushing to Cash in by Going Public, but Buoyed by Bullish Spirit, Many Find It's Easy to Move too Fast and Find Themselves Abandoned by a Fickle Market, L.A. TIMES, Aug. 26, 1997, at 1 (quoting a survey finding that a majority of 200 technology companies that went public in 1996 were mainly concerned with “finding long-term investors and investment bankers who would support them following the IPO.”); see also Jenny C. McCune, Job One: Find Money: The Best Sources and Strategies, SUCCESS, Dec. 1994. One commentator advises,

When selecting an underwriter, general counsel should consider, among other things, the underwriter's reputation for generating investor interest in a company's stock and for providing other services after the initial public offering. In this regard, consider the underwriter's distribution capability, the terms upon which the underwriter would do the offering, its industry specialization, their mix of retail and institutional customers, and post-offering support.

Steven Keith Platt, General Counsel Has a Role in Public Offerings, CORP. LEGAL TIMES, Aug. 1993, at 30.
58. Tully, supra note 18, Betrayal on Wall Street.
59. Id. ("[S]ince Wall Street is a clubby enclave dominated by a half a dozen players that regularly participate in one another's deals, it's hard for low-cost gatecrashers [investment firms charging less than 7%] to break through.")
the $121 billion raised through IPOs during the Internet boom.\textsuperscript{60}

Once an issuer has selected an underwriter, it must begin to draft and negotiate an underwriting agreement.\textsuperscript{61} There are two basic types of underwriting agreements: firm commitments and "best efforts." A "firm commitment" offering legally binds the investment banker to purchase the shares from the issuer prior to distribution to the investing public.\textsuperscript{62} The second type of underwriting agreement is the "best efforts" underwriting, which may entail several possible variations.\textsuperscript{63} Because the underwriter does not have to insure issue proceeds against uncertainties in market demand, and because the underwriter does not have to engage in pre-selling activities, best efforts underwriting generally calls for lower commissions.\textsuperscript{64} Usually, investment banks refuse to distribute the more speculative type of securities except on a best efforts basis.\textsuperscript{65} Empirically, under-pricing has been more prevalent with best efforts underwriting, than with firm commitment underwriting. This difference may be partly due to a disparity in the underwriter's and issuer's perceptions of firm value.\textsuperscript{66}

Underwriters usually bargain for an "overallotment" or "green shoe" option, which specifies a number of shares, typically 10 - 15% of the IPO offering, that they may purchase at their discretion from the issuer for thirty to forty-five days after the IPO.\textsuperscript{67} Overallotment shares allow underwriters to meet excess demand

\begin{enumerate}
\item Id.
\item See Platt, supra note 56, at 30.
\item See Hovarth, supra note 43, at 6 (stating that the "firm commitment," while more costly, is more favorable to the company, as the responsibility for the IPO shifts to the underwriter — it is now obligated to purchase all of the offered securities and then resell them.).
\item See Boyce, supra note 47, at 5.
\item See Lena Chua, A Reexamination of the Costs of Firm Commitment and Best Efforts IPOs, FIN. REV., May 1995, at 337 (stating that Benveniste & Spindt "imply that underwriter compensation is lower because underwriters do not engage in pre-selling activities," while Mandelker & Raviv claim underwriter compensation is lower because "investment bankers do not insure issue proceeds against uncertainty in the demand for the shares.").
\item See id.
\item See id.
\item See Hovarth, supra note 43, at 6.
\end{enumerate}
and satisfy requirements from institutional clients. Although an overallotment allows issuers to raise extra capital from a given offering, it really benefits the underwriter and its institutional clients when the IPO is hot. Indeed, the underwriter will typically only pay the issuer for the stock at the underwriter's standard discount rate, and not at the stock's inflated aftermarket value.

Nevertheless, an overallotment may be important for price stabilization purposes. An overallotment allows the underwriter to serve as the chief market maker in the stock and thereby maintains an orderly market.

B. Registering with the SEC

After the underwriting team has been selected, the second step in the underwriting process involves preparing a registration statement for the SEC. This requires the submission of all relevant paperwork.

68. See id. (explaining how overallotment creates incentives for institutional clients to return for more IPOs).
69. See id. (stating that overallotment may also hurt companies because selling more stock at the underwriter's discount after the stock rises considerably on the first day is detrimental to the company).
70. See id. (stating that companies may be hurt by selling shares at the discounted underwriter price).
71. See id.
72. See id. (noting that the underwriter's role as the chief market maker for the stock through overallotment is "crucial in maintaining price stability.").
73. See id.
74. In the case of an initial public offering, the relevant document will probably be an S-1 Form, or the "default" registration statement to be used by any issuer "for which no other form is authorized or prescribed." See Forms for Registration Statements, 17 C.F.R. § 239.11 (2001); see also http://www.sec.gov/info/edgar/forms.htm (last visited June 27, 2001). Form S-1 mandates rigorous disclosure concerning nearly all aspects of the issuer's business that could be of potential interest to an investor. (Sample S-1 Forms, as well all other securities registration forms, may be downloaded from the SEC's website at http://www.sec.gov. In particular, Form S-1 is available at http://www.sec.gov/divisions/corpfin/forms/s-1.htm (last visited June 27, 2001)). Form S-1 requires complete and extensive disclosure regarding the offering (e.g., plan of distribution, use of proceeds, etc.), as well as the issuer's overall business, properties, and management arrangements, and prospects. Detailed audited
Registering an offering can be extremely expensive and time consuming.\textsuperscript{75} For example, the average total cost of conducting an IPO during 1994 - 1999 was eight percent of the amount raised by the offering.\textsuperscript{76} Due to the legal and regulatory complexities involved, issuers typically rely on their underwriters, as well as experienced securities lawyers and certified public accountants, to assist them in registering IPOs with the SEC, NASD Regulation, Inc.,\textsuperscript{77} and state securities regulators.\textsuperscript{78} Accordingly, a relatively small $25 million IPO requires an estimated average cost of $2.35 million, including $1.75 million in underwriting fees, $200,000 in legal fees and $160,000 in accounting fees and expenses.\textsuperscript{79}

As discussed below, analysts working for the investment bank sponsoring the underwriting play a key role in preparing securities registration statements. Frequently, the investment bank will rely on its analysts' expertise and familiarity with the issuer for due diligence and to ensure the accuracy of the registration statement's information.\textsuperscript{80} However, the participation of analysts in financial statements for at least three fiscal years must be included. See Richard J. Hillman, \textit{Small Business – Efforts to Facilitate Equity Capital Formation}, GAO REP., Sept. 29, 2000, at 26, available at www.gao.gov. Additionally, Form S-1 specifies the information that must be set forth in the prospectus. See James D. Cox, \textit{et al.}, \textit{Securities Regulation Cases and Materials} 45 (2d ed. 1997). Finally, no incorporation by reference is allowed. Presumably, intentional underpricing would need to be disclosed. The S-1 Form indicates how many shares are going to be included in the offering, and describes a price range for each share. However, the registration statement will not contain a final price. See generally, Hovarth, \textit{supra} note 43, at 6. That price is only determined after the underwriter and the issuer have taken the offering “on the road.” \textit{Id.}

\textsuperscript{75} See Hillman, \textit{supra} note 74, at 23-24.

\textsuperscript{76} See \textit{id.}

\textsuperscript{77} NASD Regulation, Inc. is the independent subsidiary of the National Association of Securities Dealers (NASD), Inc., and is authorized to regulate the securities industry and the NASDAQ Stock Market. See http://www.nasdr.com/2200.htm (last visited June 27, 2001) (stating that the NASD was created in 1938 by the Maloney Act amendments to the Securities Exchange Act of 1934); see also Maloney Over-the-Counter Market Act, Pub. L. No. 75-719, 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. §§ 78o, 78o-3, 78cc, 78ff, 78q (2000)).

\textsuperscript{78} See Hillman, \textit{supra} note 74, at 23.

\textsuperscript{79} \textit{Id.}

\textsuperscript{80} See Dennis J. Block & Jonathan M. Hoff, \textit{Underwriter Due Diligence In
underwriting transactions raises troublesome independence concerns and a potential for bias in the analysts' research reports. Moreover, analyst access to the issuer's confidential information may expose analysts and their employers to liability for insider trading.

C. The Road Show

I. A Forum to “Test the Waters” of Market Interest

Underwriters do not take issuers public unless there is sufficient market interest. If there is insufficient interest in a particular offering, it may be scaled down or discarded altogether. Therefore, the underwriter must first evaluate the market interest in each offering. The underwriter “ideally has contacts among institutional money managers who might be interested in purchasing the [issuers] shares” whom it will survey and ascertain what quantities of the offering they desire. Thus, the investment banker will usually have a good indication beforehand whether an IPO will be “hot.”

As mentioned earlier, to generate interest in a particular offering and to evaluate market demand, investment bankers typically sponsor a “road show” that introduces the offering to potential major purchasers. During the road show, institutional investors, security analysts and broker dealers meet the issuer's

Securities Offerings, N.Y.L.J., May 27, 1999, at 5 (analyzing the problems which may arise if underwriters fail to maintain a “Chinese Wall” between their analysts and their brokers).
81. See id.
82. See id.
84. Id.
85. See id.
86. Id.
management team and learn about the issuer. The issuer's CEO, CFO and other senior management members usually make brief speeches and presentations discussing the issuer's business strategy and financial outlook. Road shows frequently feature live shows, videotapes, and other multimedia materials, as well as oral statements not found in the written prospectus. Generally, group presentations are supplemented with one-on-one meetings between the issuer and those institutions interested in purchasing large blocks of stock. However, the only written material distributed to attendees is the preliminary prospectus contained in the registration statement.

2. Statutory Requirements

Road shows are subject to strict legal requirements. The SEC has indicated that an issuer may "test the waters" to determine market interest prior to an offering. However, there cannot be any solicitation or acceptance of money until the SEC has completed its review of the registration statement and authorized its issuance. To appreciate the ability of underwriters to generate hot IPOs, it is important to understand the legal framework they must negotiate before their road show information can be fully exploited.

The Securities Act of 1933 ("Securities Act") significantly restricts the ability of issuers to generate publicity about securities offerings. Section 5 of the Securities Act divides the public

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89. See Hovarth, supra note 43, at 6.
90. See Allen, supra note 88, at 340.
91. See id. at 341.
92. See Eddy, supra note 44, at 870.
93. See id.
offering process into three stages, each with distinct legal consequences: (1) the pre-filing period, (2) the waiting period, and (3) the post-effective period. The pre-filing period, describes the stage during which a registration statement has yet to be filed with respect to the security being offered. During the waiting period, a registration statement has been filed, but has not yet been approved by the SEC. When the SEC finalizes the registration statement and declares it to be in effect, the securities offering is said to have entered the post-effective period.

During the pre-filing period, no sales activity of any kind may take place. Section 5(c) of the Securities Act prohibits any person from making oral or written offers to sell any security unless a registration statement has been filed with the SEC with respect to that security.

Although virtually no advertising is permitted during the waiting period, potential investors may be introduced to the offering through the statutorily defined “prospectus.” All solicitations of offers to buy the registered securities can be made only by prospectus. However, no transaction to purchase securities may yet be concluded — sales are only permitted during the post-effective period, whether originated from oral or written offers to sell.

Unless an exception applies, Section 5(a) prohibits any person from selling a security in interstate commerce unless the SEC

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99. See id. at 249.
100. See id.
101. See id.
104. Estreicher, supra note 102, at 279 (“From the filing of the registration statement until the effective date — the so-called ‘waiting period’ — virtually no advertising is permitted except through distribution of the statutorily defined ‘prospectus’.”).
105. See id. at 280-81.
declares that the registration statement is in effect. In other words, sales may not be finalized until the post-effective period.

Road shows are typically conducted during the waiting period. Except for the preliminary prospectus, road shows involve nothing more than oral and visual communications. Oral offers to sell, whether in person or by telephone or other electronic means, are unrestricted during the waiting period. However, no offer, whether oral or in writing, may be accepted until the SEC has declared the registration statement to be in effect. Accordingly, issuers are barred from selling any securities offered during a road show. Traders for both the institutional investor and the underwriter must therefore carefully couch their negotiating language so that they do not include any promises or specific numbers.

Not surprisingly, "prospectus" is a term of art that is broadly defined. Section 2(a)(10) of the Securities Act defines a "prospectus" as "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security," and sets out the exceptions to that definition. According to

107. See Eddy, supra note 44, at 872.
108. Id. at 873.
109. See id. at 872.
111. See Eddy, supra note 44, at 874.
112. See Carol Vinzant, Public Offering, Private Deal; Probes, Lawsuits Shed Light on Secret World of Wall Street's Once-Hot IPO Market, WASH. POST, June 17, 2001, at H1. Moreover, any offer tendered during a road show must conform to strict statutory requirements to ensure that it is not treated as a written offer under the law. In pertinent part, Section 5(b)(1) provides that, "it shall be unlawful for any person ... to carry or transmit [in interstate commerce] any prospectus relating to any security with respect to which a registration statement has been filed ... unless such prospectus meets the requirements of Section [10]." 15 U.S.C. § 77e(b) (2000) (otherwise known as Section 5(b) of the Securities Act of 1933).
113. 15 U.S.C. § 77(b)(10) (2000). A communication that would otherwise be a prospectus is not so deemed "if it states from whom a written prospectus meeting the requirements of Section [10] ... may be obtained and, in addition, does no more than identify the security, state the price thereof, state by whom
Section 10(a), a prospectus "shall contain the information contained in the registration statement." Therefore, any offer to sell a security during the waiting period must be accompanied by a statutory prospectus. Oral and visual communications during a road show do not fall under the definition of a prospectus under Section 2(a)(10), which only applies to written material. Accordingly, road shows properly conducted during the waiting period do not violate Section 5(b)(1) of the Securities Act nor any other statutory proscription.

As a practical matter, at the time of the filing of the registration statement, parties to a syndication agreement may leave certain specific terms unfinalized. For example, the price of the offered securities, discounts and commissions to underwriters and dealers, and other information about the underwriting syndicate are often disclosed only on the eve of the effective date of the registration statement. Section 10(b) allows such omission,

orders will be executed, and contains such other information as the Commission . . . may permit." Id.

Pursuant to Section 2(a)(10), the SEC promulgated Rule 134, entitled "Communications Not Deemed a Prospectus," which allows the issuer to release, during the waiting and post-effective periods, communications intended to serve not as selling documents, but as a means to assess market interest in the prospective securities offering. See 17 C.F.R. §230.134 (2001). Rule 134 prescribes the information that a so-called "tombstone ad" or "identifying statement" may contain. See id. Without constituting a prospectus, such communications may contain, the full name of the issuer, the type of security offered, the price or price range of the security, the names of the managing underwriters, and the date that the proposed sale will commence, or any of eight other specified items. See id. Circulars, notices, press releases or any other type of communication whether written or transmitted by radio or television can meet the requirements of Rule 134. See id. A tombstone ad must identify a person from whom a Section 10 prospectus may be obtained. See id.

115. See Eddy, supra note 44, at 873 (stating that "[b]ecause traditional road shows are nothing more than oral and visual communication, and not written communication, they are not themselves deemed to be prospectuses under Section 2(a)(10).").
116. See id. at 872.
118. See id.
stating that the SEC "shall... permit the use of a prospectus for the purposes of [Section 5(b)(1)], which omits in part or summarizes information in the prospectus specified in subsection (a)...."119

Accordingly, Rule 430 of the Securities Act provides that during the waiting period written offers may be made by way of a "red herring" or preliminary prospectus.120 Under Rule 430, a prospectus will satisfy the requirements of Section 10 of the Securities Act for purposes of Section 5(b)(1) provided that it "contains substantially the information required by the Act and the rules and regulations thereunder...."121 In particular, a preliminary prospectus may omit information regarding "offering price, underwriting discounts or commissions, discounts or commissions to dealers, amount of proceeds, conversion rates, call prices, or other matters dependent upon the offering price."122 The investment banker’s temporal flexibility in setting the offering’s final price, namely the ability to wait until the eve of the registration statement’s effectiveness, is central to the hot IPO phenomenon.

3. Retail Investors Are Typically Excluded

During the road show, the issuer communicates important market information about its business prospects to a narrow, select audience.123 According to one commentator, the public is "about as likely to find out what goes on at road shows as it is to find out what’s been happening inside the Oval Office."124 Indeed, it is the law that mandates this inequitable two-tier system of disseminating

120. See Prospectus for Use Prior to Effective Date, 17 C.F.R. § 230.430 (2001).
121. Id.
122. Id.
123. See Susan Antilla, Wall Street Takes Road Shows Online, PLAIN DEALER, Feb. 23, 1998, at 3D ("Electronic road shows do little to correct one inequity in the way information is disseminated about new underwritings.").
124. Lawrence A. Cunningham, securities law professor at the Benjamin N. Cardozo School of Law, quoted id.
information about new offerings to the market.\textsuperscript{125}

Road shows commonly include securities offerings that are exempt from registration under a safe harbor provision, such as Regulation D or Rule 144A.\textsuperscript{126} To benefit from a "safe harbor" exemption, issuers and promoters must satisfy strict regulatory requirements.\textsuperscript{127} Both Regulation D, applicable to private placements, and Rule 144A, applicable to institutional investors, require that underwriters pre-clear audience participants as "accredited investors" at road shows where restricted securities are being offered.\textsuperscript{128}

Regulatory standards are strictly applied. For example, Rule 144A provides a safe harbor exemption from the Securities Act registration requirements.\textsuperscript{129} Broker-dealers who want to participate in a Rule 144A offering, whether purchasing for their own accounts or otherwise, must own at least $100 million in securities.\textsuperscript{130} Attendance at a road show by investors that do not meet these characteristics is a violation of Section 5 of the

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\begin{footnotes}
\footnote{125}{See generally, Satu S. Svahn, Greater Investor Outreach at the Click of a Mouse: Internet and Closed-Circuit Roadshows Should Reach Retail Investors, 65 BROOK. L. REV. 249 (1999) (advocating the SEC's proposed "aircraft carrier" rule which would allow retail investors to get access to road shows).}
\footnote{126}{17 C.F.R. § 230.508 (2001); 17 C.F.R. § 230.144A (2001); see also Schulte Roth & Zabel LLP, IPO Road Shows in the Electronic Age: SEC No-Action Letters Addressing Use of the Internet and Closed Circuit Systems, MONDAQ. BUS. BRIEFING, June 2, 1999 (discussing five road shows offered over the Internet or closed circuit TV, one of which was exempt from registration under 144A).}
\footnote{127}{See 17 C.F.R. § 230.508 (2001); 17 C.F.R. § 230-144A (2001); see also Roberta S. Karmel, Is §5 an Anachronism?, N.Y.L.J., Dec. 21, 1995, at 3 (detailing the requirements that issuers and promoters must meet to fall under safe harbor exemptions).}
\footnote{129}{The exemption is for specified sales of restricted securities to qualified institutional buyers ("QIBs"), namely institutions that in the aggregate own and invest on a discretionary basis at least $100 million in securities. See 17 C.F.R. § 230.144A (2001).}
\footnote{130}{Id.}
\end{footnotes}
Sellers are held to the "reasonable belief" standard with respect to the status of a buyer during a Rule 144A offering. Even when a road show does not involve restricted securities, retail investors are typically excluded. By excluding retail investors, underwriters may seek to protect themselves against liability for innocent or unintentional misrepresentations. Oral statements made at road shows are subject to the antifraud provisions of the securities laws. For example, Section 12(a)(2) of the Securities Act provides that a civil action may be brought against any person who offers or sells securities "by means of prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in light of the circumstances under which they were made, not misleading."

Irrespective of the underwriters' interest in excluding retail investors from road shows, such exclusion is inconsistent with the

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131. Id.
132. See Karmel, supra note 127, at 3.
135. 15 U.S.C. § 77l (2000) (emphasis added), otherwise known as Section 12(a)(2) of the Securities Act of 1933. Other potential causes of action involve Section 11 of the Securities Act and Rule 10b-5, 15 U.S.C. § 77k (2000); Section 11 generally holds those individuals who signed the underwriting statement liable for any misstatements contained therein on which an investor relies when purchasing a security. 15 U.S.C. § 77k (2000). Section 11 does not apply to oral misstatements, and requires that plaintiff show reliance on defendant's misstatements. See id. Rule 10b-5 is a general anti-fraud provision promulgated under Section 10(b) of the Securities Act that provides investors with an implied cause of action over the use of "manipulative and deceptive devices" in the securities market. See 17 C.F.R. § 240.10b-5 (2001). Although it applies to oral misstatements, it requires plaintiff to show both reliance and scienter. See Singh, supra note 47, at 547. Under Section 12(a)(2), by contrast, a plaintiff may succeed by showing a failure to exercise reasonable care. See id.
policies of Regulation FD, discussed below. It puts retail investors in a position where the only thing they know about upcoming offerings comes from analyst-filtered information, fed by parties who may be on the underwriter’s payroll. Moreover, a blanket exclusion seems particularly inappropriate in light of technology currently available, such as the Internet.

4. The “Order Book”

During or after the road show presentations the investment banker’s task is to evaluate market interest. Indications of interest are recorded in a so-called “order book.” “The objective is usually to oversubscribe the issue by two or three times, which will pretty much guarantee that the whole issue can be sold on pricing day.”

At peak periods, an issuer’s offering book may be oversubscribed by as many as twenty or thirty times. That rate of oversubscription is important, as it gives the underwriter an indication of the extent to which demand exceeds supply at a given price. Though, as discussed below, expressions of interest recorded in the order book are not binding by operation of law, a broadly oversubscribed order book typically means that the IPO will be “hot.”

137. See generally, Eddy, supra note 44, at 881 (supporting the such expansion of road show information and noting “[w]ith increased technology and Internet access, retail investors should be able to benefit from potential reductions in informational asymmetries.”).
138. See Hovarth, supra note 43, at 6; Ed McCarthy, Pricing IPO’s: Science or Science Fiction, J. OF ACCT., Sept. 1999, at 51 (“For example, the investment banker will know that, at $14 per share, the offering is oversubscribed 4 times; at $15, it’s oversubscribed 2 ½ times, and so on.”).
139. McCarthy, supra note 138.
141. Cf. id
142. See id.
D. The "Go-Ahead"

1. Pricing

Once the SEC declares a registration statement effective, the underwriter sets a final price for the offering, and trading usually begins within a day. Determining the final price for an IPO, however, is just the last step in a lengthy process.

At the outset of a public offering, the issuer and the underwriter typically negotiate a range of acceptable prices for the stock that will be distributed. To arrive at that range, some accounting benchmark must generally be used. During the Internet boom, Internet companies were valued using a number of absurd criteria. The exorbitant prices of technology stocks were often justified on the basis of non-financial merits such as web traffic, "page views per user" and "engaged shoppers," with no empirical evidence that these criteria translated into future profits or revenues.

Obtaining an estimate for the value of a stock would have been a more straightforward affair during less heady times. The standard valuation method traditionally involves assessing the issuer's net income, attaching a multiple which factors for the

144. See Hovarth, supra note 43, at 6.
146. See McCarthy, supra note 138.
147. Gretchen Morgenson, How Did They Value Stocks? Count the Absurd Ways; Those Lofty 'New Economy' Measures Fizzle, N.Y. TIMES, Mar. 18, 2001, at C1. The exorbitant price of Internet stocks was based in part on a litany of information that did not reliably indicate a company's profits or revenues. See id. Examples of such non-financial information included customer loyalty, website traffic, and engaged shoppers. See id.
issuer's growth prospects and the time value of money, and company-specific market risk. The multiple incorporates into the IPO's price estimate such intangible values as the quality of the issuer's management team, the company's position in its major markets, the value of its technology, and its capacity for innovation. Traditionally, a issuer would need to demonstrate a consistent track record of profits and stable growth before it could launch an IPO. In contrast, Internet companies pioneered new activities and seldom, if ever, showed a profit. As discussed below, Wall Street's response was to abandon traditional valuation methods and to develop completely new substitutes.

Financial or accounting yardsticks do not predetermine an IPO's final price. Ideally, market demand should be the sole arbiter of a security's final price. Under the efficient market hypothesis — absent manipulation or other market imperfections — the price established by market demand approximates the best possible valuation methods. The offering price negotiations with the startup usually proceed on the basis of apparent market demand, and conclude within twenty-four hours of the issue's initial day of trading. To assess market demand, the underwriter relies on information collected during the road show and captured

148. See McCarthy, supra note 138.
149. See id.
150. See id.
151. See id.
152. See id. ("[I]nstead of valuing the cable companies traditionally, at some multiples of earnings, for example . . . valued the firms based on their installed customer base. This led to a valuation multiple based on the cable company's subscribers.").
154. Id.
155. See Stephen J. Schulte, IPO Roadshows Today: A Primer for the Practitioner, 1068 PLI/CORP. 527, 533 (Sept. 1998) (explaining that the short turn-around period maximizes the accuracy of the negotiated offering price, and that given too much time in between the conclusion of negotiations and the actual offering of securities to the public, the price will move too far north or south).
in the order book. The underwriter will apply such information to narrow the range of possible prices initially filed with the SEC into a single, definite price.

2. Under-pricing

Though IPOs have usually been under-priced, trading price run-ups during the first day of trading were particularly intense at the end of the last decade. While hot IPOs have traditionally experienced price run-ups of up to twenty-five percent in the first day of trading, during 1998 and 1999 run-ups of up to 200% were not uncommon. In one egregious instance, a particular stock surged 900% over its offering price during the first day of trading.

In 1999 and 2000, first day offering prices on average jumped 71% and 57%, respectively, during the first day of trading. That compares with an average of 11% from 1980 to 1998.

As the quantity of shares that will be distributed in the offering is fixed in the registration statement, investment bankers cannot align demand and supply by simply issuing and distributing more shares. Instead, IPOs that have been under-priced relative

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156. See id.
158. See Hovarth, supra note 43, at 6. The systematic underpricing of IPOs is a thoroughly documented empirical fact that has been documented for many years. See, e.g., Anthony Saunders, Why Are So Many New Stock Issues Underpriced?, BUS. REV., Mar./Apr. 1990, at 3 (“Considerable evidence shows that new or initial public equity offerings...are underpriced on average.”); John C. Coffee, Jr., IPO Underpricing and Dutch Auctions, N.Y.L.J., Sept. 16, 1999, at 5 (noting that “the phenomenon of IPO underpricing [is] long a standard feature of initial public offerings.”); see also Coffee, The IPO Allocation Probe: Who Is the Victim?, supra note 14, at 5.
160. Miriam Hill, Companies Don't Complain as Money Managers Cash in on Their IPOs, PHILA. INQUIRER, Mar. 1, 1999. The IPO in question was the Nov. 1998 distribution of TheGlobe.com, which grabbed headlines as the biggest IPO run-up in history. See id.
161. Tully, Betrayal on Wall Street, supra note 18.
162. Id.
163. In SEC filings, the quantity of shares to be distributed is fixed, but not the
to indications of market interest typically undergo a price "pop" during the first day of trading, or an immediate run-up in value that aligns supply and demand in the aftermarket. It is the price pop that makes the IPO "hot."

According to NASD regulations, underwriters have almost unlimited discretion with respect to IPO allocations that do not involve broker-dealers. Upon determination of the offering price, hot IPOs are typically sold and transferred overnight into the accounts of those institutional investors that enjoy a good business relationship with the underwriter. Retail investors typically lack access to hot IPOs, and even when they are able to participate, they may be proscribed from cashing in their shares by restrictive lock-up agreements. Meanwhile, the institutional investors “flip” or “spin” their stock allocations to secure an immediate profit from the IPO’s inflated trading price in the aftermarket.

3. The Effects of Under-pricing on the Issuer

Underwriters in the United States typically require a flat fee for the IPO’s distribution, commonly equal to seven percent of the final offering price. Given the prevalent percentage-of-the-take fee structure, it seems counterintuitive that investment bankers purposefully attempt to under-price IPOs. Yet, during 1999 and 2000, at the height of the Internet craze, investment bankers left as much as $62 billion “on the table” by under-pricing IPOs. For example, Netscape left $151 million on the table during its 1995 IPO, or $11 million more than the amount the company raised

164. See NASD Free Riding and Withholding Interpretation, Rules 0100-3420 [hereinafter NASD Free Riding and Withholding Interpretation]. Note that the citation to the Free-Riding and Withholding Interpretation is “IM-2110-1,” which means Interpretative Material under NASD Conduct Rule 2110, first interpretation; see also the accompanying discussion in text infra Part III.B.1.
165. See Hill, supra note 160.
166. See id.
167. See id (unlike the retail purchasers, "the institutions often sell their shares at the opening of public trading.").
168. Id.
169. Tully, Betrayal on Wall Street, supra note 18.
At first blush, it may seem gratifying to company executives that their IPO was so successful that it opened with a “price pop.”\textsuperscript{171} A price run-up during the first day of trading would seem to justify management’s efforts to market and publicize the company’s good prospects.\textsuperscript{172}

However, a price pop is a telltale sign that an IPO has been sold at an artificially low price. When a “price pop” occurs, investors who could not get enough shares during the initial offering try to “snap them up” in the aftermarket from investors who value them less than they do.\textsuperscript{173} An under-priced IPO can be devastating for the issuer, diluting its stock and depriving it of capital needed to fund research and development, launch marketing campaigns, or simply stay afloat.\textsuperscript{174} Moreover, an under-priced IPO dilutes the holdings of the original stakeholders and allows ownership of the firm to be transferred at a low price.\textsuperscript{175}

4. The Alibis

Despite the negative impact of a hot IPO on the issuer, underpricing commonly takes place with the issuer’s management’s implicit or express approval.\textsuperscript{176} As detailed below, this may be a consequence of NASD regulations that allow the issuer to place hot IPOs in the hands of management and other corporate insiders. This apparent complicity by issuers has led to speculation that hot IPOs are not a wholly innocent affair.\textsuperscript{177}

Certainly, there are some innocent explanations for the

\begin{itemize}
  \item \textsuperscript{170} See Vinzant, \textit{supra} note 112, at H01.
  \item \textsuperscript{171} See McCarthy, \textit{supra} note 138.
  \item \textsuperscript{172} \textit{See A Penny in Whose Pocket?}, ECONOMIST, May 26, 2001 (“A big first-day pop in [the issuers’] share price was viewed as a marketing success.”).
  \item \textsuperscript{173} See McCarthy, \textit{supra} note 138.
  \item \textsuperscript{175} Id. (including helpful examples).
  \item \textsuperscript{176} See Mark D. Seltzer, \textit{‘Spinning’ Hot Stocks: Is It a Crime?}, BUS. CRIMES BULL. COMPLIANCE & LITIG., Sept. 1998, at 7.
  \item \textsuperscript{177} See Hill, \textit{supra} note 160; \textit{A Penny in Whose Pocket?}, \textit{supra} note 172.
\end{itemize}
systematic under-pricing of IPOs. For one, it has been argued that stabilizing activities by the underwriter account for the rise in the average price of stock sold in an IPO.\textsuperscript{178} Accordingly, underwriters may simply be doing their best analysis in a market where the demand for new issues is high and unusually volatile.\textsuperscript{179} However, it is unlikely that stabilizing activities can adequately explain the excessive price run-ups that were regularly seen during the Internet boom.

Another possible explanation for IPO under-pricing involves the need to guarantee that the issue gets distributed quickly.\textsuperscript{180} Firm commitment underwriters are especially apprehensive about setting too high a price for an offering.\textsuperscript{181} As such, an underwriter may want to price the IPO lower than it deserves.\textsuperscript{182}

Moreover, the price for an under-subscribed IPO can easily collapse.\textsuperscript{183} In that case, the underwriter must either subscribe itself to the issue or sell the stock at a deflated price, incurring substantial per share losses.\textsuperscript{184} It may therefore make sense for a firm commitment underwriter to regularly under-price IPOs despite the industry's flat seven percent per share fee structure.\textsuperscript{185} These justifications are not entirely plausible, however, because it

\textsuperscript{178} See Royce R. Barondes, \textit{Dynamic Economic Analyses of Selected Provisions of Corporate Law: The Absolute Delegation Rule, Disclosure of Intermediate Estimates and IPO Pricing}, 7 DEPAUL BUS. L. J. 97, 127 n.105 (1994). Stabilizing refers to the practice of underwriters to systematically bid for or purchase securities subject to distribution at a price just below the offering price in order to maintain an orderly market; the aftermarket for new issues can be thin and very unpredictable. \textit{See id.}

\textsuperscript{179} See Hill, \textit{supra} note 160 (noting that "[b]oth the investment bankers and the issuers they take public say they are doing their best in a market in which new issues go from cold to hot overnight.").

\textsuperscript{180} See Rasheed, \textit{supra} note 175, at 11.

\textsuperscript{181} In a firm commitment offering, the underwriter agrees to purchase all the shares in the offering before they are distributed to investors. Firm commitment offerings tie up the underwriter's capital, thereby providing an incentive to dispose of all the shares quickly. \textit{See generally}, McCarthy, \textit{supra} note 138.

\textsuperscript{182} \textit{See id.}

\textsuperscript{183} Rasheed, \textit{supra} note 175, at 11.

\textsuperscript{184} \textit{See id.}

\textsuperscript{185} \textit{See id.} (stating that because of firm underwriting commitments, "it may actually be in the best interest of the underwriter to keep the issue price relatively low.").
has been empirically demonstrated that best efforts underwriting typically results in more severe under-pricing than firm commitment underwriting.\textsuperscript{186} The influence of institutional politics and public relations provides another possible innocent explanation for the IPO underpricing phenomenon.\textsuperscript{187} According to some industry observers, an IPO’s offering price should never be determined solely on the basis of market demand considerations.\textsuperscript{188} A high-priced offering may come back to haunt the issuer and the underwriter in the form of lawsuits from disgruntled investors who have incurred losses from a price collapse.\textsuperscript{189}

Moreover, the issuer has a vested interest in keeping institutional investors happy because they hold the keys to successful secondary offerings.\textsuperscript{190} It may therefore be against the issuer’s long-term interest to hoard stock gains by requiring a high offering price during its IPO.\textsuperscript{191} Instead, the first issue should be

\textsuperscript{186} See, e.g., Jeffrey N. Gordon, \textit{Contractual Freedom in Corporate Law: Articles and Comments; The Mandatory Structure of Corporate Law}, 1989 COLUM. L. REV. 1549 n.42 (referring to a five-year survey which showed that investors in best efforts offerings are compensated by a greater underpricing effect than firm commitment investors).

\textsuperscript{187} Ed McCarthy, for example, advocates “keeping everybody happy” – although the company hires the underwriters and pays the IPO fees, the investment banker must balance the conflicting goals of several audiences. The issuer wants the highest price – within reason – for its shares, while investors want to pay the lowest price. Overpricing the issue increases the risk of a poor after-market performance, which can lead to lawsuits from disgruntled investors . . . “[L]eaving something on the table” serves several purposes. It entices institutional investors to buy the issue because they are getting a bargain, and their participation is usually critical to selling out an issue. Assuming the stock’s price moves up to its fair value in the after-market — the IPO price “pop” — investors earn a fast return as a reward for investing in an unseasoned issue. Underpricing also serves a defensive purpose. Should a disgruntled investor claim the issue was overpriced, the investment bank can point to its valuation method and the discount as evidence of its conservative practices.

\textsuperscript{188} See \textit{id.}

\textsuperscript{189} See \textit{id.} (noting that overpricing an IPO increases the risk of poor after-market performance, possibly resulting in lawsuits from disgruntled investors).

\textsuperscript{190} See Hovarth, \textit{supra} note 43, at 6.

\textsuperscript{191} See \textit{id.}
purposely under-priced in order to “leave a good taste in investors’ mouths.”

5. The Damning Version

Although the above are all plausible explanations for some instances of IPO under-pricing during the Internet boom, the problem was so severe, widespread, and persistent that a more sinister account has been gaining increasing currency among the media, Congress, and academics.

Oversubscribed IPOs are, by their very nature, a scarce commodity. Any investor lucky enough to be allocated shares of a hot IPO is virtually guaranteed a risk-free profit by “flipping” it in the aftermarket. Investment banks are under a legal obligation to make a bona fide distribution of a securities offering. In other words, an investment bank is barred from hoarding hot IPOs or itself flipping them. However, an investment bank generally has full discretion in allocating all IPOs, at least as long as certain restricted individuals such as broker-dealers do not receive any. The investment bank typically allocates IPOs to preferred clients, such as institutional investors. However, there is often a quid pro quo in effect, which may either be explicit or implicit depending on the circumstances. If the institutional investor expects to receive hot IPOs in the future, it must behave like a good client — increasing its trading volume at the investment bank and thereby

193. See generally, Elstrom, supra note 2, at EB16; Toedtman, supra note 2, at A63; see also Coffee, The IPO Allocation Probe: Who Is the Victim?, supra note 14, at 5.
195. See id. at 6.
196. See id.
197. See id. (“Nor do SEC or NASD rules attempt to confine the underwriter’s discretion [in regard to who receives IPO shares], at least so long as the underwriter does not allocate to itself, affiliates, or others within the underwriter community.”).
198. Id.
the amount of commissions.\textsuperscript{199}

A small investor with no Wall Street connections will typically be locked out of a hot offering at least until it reaches the aftermarket.\textsuperscript{200} However, small investors played a key role in the Internet boom, by feeding into the insatiable market appetite for technology stocks and driving up the prices and trading volumes.\textsuperscript{201} Analysts on the payroll of Wall Street investment banks induced that frenzied demand for new issues by painting rosy forecasts that were nothing better than crass sales pitches.\textsuperscript{202}

In fact, the reputation of the “hallowed Wall Street analyst” has been so battered by the profession’s behavior during the Internet boom that the SEC recently took the unprecedented step of explicitly advising investors not to rely solely on analysts’ reports when they make decisions about buying and selling stocks.\textsuperscript{203} This move followed a surge of complaints by investors who lost heavily by adhering to analyst recommendations.\textsuperscript{204} According to the SEC, analysts are frequently in a position of an inherent conflict of interest.\textsuperscript{205}

Assisted by armies of irrepressibly optimistic analysts, Wall Street investment banks corrupted the IPO process into a form of quasi-legal commercial bribery, with which to attract their institutional clients, venture capitalists, corporate executives, and others. Indeed, Wall Street insiders have profited handsomely from IPOs. According to Wall Street syndicate managers, institutional investors such as mutual funds acquire about sixty

\textsuperscript{199} See id. (“[S]ome among the favored few that receive ‘hot’ IPO allocations appear to have paid for the privilege – typically in the form of above-market brokerage commissions. Different means exist by which the underwriters’ affection can be so purchased.”).

\textsuperscript{200} See id.

\textsuperscript{201} Gretchen Morgenson, \textit{Regulators Are Waking Up to Conflicts}, N.Y. TIMES, June 10, 2001, § 1, at 3.

\textsuperscript{202} See id.


\textsuperscript{204} See id.

\textsuperscript{205} See id (noting that conflicts arise when the research department is too closely tied to the brokerage department, when analysts own the stock that they write about, and when a firm’s investment banking arm pays the analyst for her work).
percent of the typical IPO offering and as much as eighty percent of the shares of certain big IPOs.\textsuperscript{206} During 1999 and 2000, eighty percent of an offering usually went to about 125 mutual funds, which quickly flipped their stock in the aftermarket and collected risk-free profits.\textsuperscript{207} "Within a week or two, all but ten or 15" would "dump" their shares.\textsuperscript{208} Moreover, institutional investors usually got the best IPOs — retail investors got 46\% of the IPOs that either fell or were flat on the first day of trading, but only 24\% of the IPOs that rose dramatically.\textsuperscript{209}

\textbf{E. The Lock-up Period}

The last stage of the underwriting process involves the lock-up period. Parties subject to a lock-up agreement cannot sell the stock obtained in an offering until the expiration of the agreement.\textsuperscript{210} According to some critics, lock-up agreements serve to further disadvantage small investors while adding fuel to an already hot offering.\textsuperscript{211}

Lock-up agreements can serve to maintain price stability and preserve investor confidence by ensuring that insiders or other holders of substantial blocks of stock cannot dump their stock shortly after the offering and cause panic selling.\textsuperscript{212} Parties subject to a lock-up agreement will generally hold their shares even after the agreement has expired.\textsuperscript{213} Nevertheless, panic selling is an all too real possibility that may negatively affect an issuer's prospects

\textsuperscript{206} See Zweig & Spiro, supra note 27.
\textsuperscript{207} See Tully, Betrayal on Wall Street, supra note 18.
\textsuperscript{208} Id.
\textsuperscript{209} Vinzant, supra note 112, at H01 (quoting Irv DeGraw, research director at WorldFinanceNet, as saying, "[a]s an individual, if you can get all of an offering you want, you don't want it.").
\textsuperscript{210} See id.
\textsuperscript{211} See Stuart Varney, IPO Experts Agree Offerings Come Out in 'Rigged Market', CNN, May 30, 1995 (citing experts who argue that the IPO process is thoroughly manipulated by underwriters).
\textsuperscript{212} See Lock-Up Expiration Fear Is Unfounded, IPO REP., May 1, 2000.
\textsuperscript{213} See id. (referring to a recent Thomson Financial Investor Services report which stated that, "[i]nvestor relations officers that worry about their company's stock price slipping after the lock-up period expires should not be concerned . . . ").
for future financing. For example, the stock price for Divine Interventures tumbled 35% in a single day, when forty million of Divine’s 136 million shares became eligible for trading after the expiration of a lock-up agreement.

However, lock-up agreements can assist in generating hot IPOs, particularly when stock that is subject to a lock-up is sold not to insiders or institutional investors, but to the general public. Indeed, plaintiffs in securities litigation arising from the aftermath of the Internet boom have suggested that lock-up agreements may be illegal because they constrict supply and discriminate among classes of customers. The agreements may help trigger a price explosion the first day of trading, inducing small investors to buy at inflated prices. At the same time, institutional investors or other favored customers of the underwriter, who are not subject to lock-ups or are able to successfully challenge their enforcement, happily sell.

III. THE ROLE OF ANALYSTS

The Supreme Court has recognized that analysts play a crucial role in maintaining a healthy market by providing an objective evaluation of the prospects of individual companies. Indeed, analysts play a key role in evaluating, verifying, and researching corporate disclosures required by the securities laws, and in disseminating company-specific information to the market as a whole. According to the SEC, “analysts actively seek out bits

214. See id. (“However, [Thomson Financial Investor Services Senior Managing Director Richard Wines] warned that companies should expect some degree of volatility in the period following the expiration of the lock-up period.”).
217. See id.
218. See id.
219. See id.
221. See Paul B. Brountas, Jr., Note, Rule 10b-5 and Voluntary Corporate
and pieces of corporate information not generally known to the
market for the express purpose of analyzing that information and
informing their clients who, in turn, can be expected to trade on
the basis of the information conveyed." Analysts obtain earnings
data and forward-looking information, and check for accuracy,
frad, and bias. Also, analysts systematically collect information
regarding federal actions, interest rates, and social and economic
trends to evaluate their impact on the companies they that
evaluate. Analysts then issue investment recommendations to
their employers, a select group of clients, or to the investing public
as a whole.

Analysts, however, sometimes mislead small investors when
disseminating corporate information. Some commentators have
alleged that this problem is particularly acute in the IPO context.
In congressional hearings, analysts have been accused of
manipulating small investors, by way of wildly optimistic forecasts,
into purchasing stock underwritten by the analysts' employers.
On the other hand, some Wall Street analysts work at research-
only investment houses, typically affiliated with a broker-dealer,

223. See Brountas, supra note 221, at 1520.
224. See id.
225. See id.
226. Susan Pulliam, Abercrombie & Fitch Ignites Controversy over Possible
227. According to a New York Times editorial –
Simply put, the independence of analysts' research was often subverted to serve
the interests of their firms' highly profitable investment banking operations.
Fearful that negative research reports would curtail their ability to land
opportunities to underwrite initial public offerings, some firms had their deal
makers review analysts' work, and tied the analysts' compensation to income
from deal-making in the industries they cover.
228. See Gretchen Morgenson, Wall Street's Analysis Put on the Defensive at a
Hearing, N.Y. TIMES, June 15, 2001, at C4. This behavior is credited to the
unethical conduct of analysts and conflicts of interests that pervade Wall Street.
Id. Recently the Securities Industry Association issued a voluntary set of
standards for practice, one change in particular is that research departments
should not report to investment banking executives. Id.
that do not engage in capital market transactions with the companies they cover.\textsuperscript{229} Other analysts work on the buy-side for institutional investors and rarely publish their research.\textsuperscript{220}

Nonetheless, analysts play an integral role when investment banks solicit issuers as underwriting clients.\textsuperscript{231} Generally, issuers prefer an underwriter whose analysts can provide long-term support.\textsuperscript{232} Moreover, investment banks rely on analysts' knowledge of the issuing business during the pre-IPO due diligence investigation that is required by securities laws.\textsuperscript{233} Analysts also support the sales and marketing aspect of the underwriting process, and provide the quarterly and yearly earnings estimates that are used to help determine price.\textsuperscript{234} Finally, analysts typically issue a positive report on the issuer, usually twenty-five days after the offering, in order to maintain interest in the offering and to facilitate price stabilization.\textsuperscript{235}

There is an inherent conflict of interest between the research and underwriting aspects of investment banking.\textsuperscript{236} Some company executives refuse to hire those investment banks whose analysts have downgraded the company's stock in the past.\textsuperscript{237} Investment

\begin{flushleft}
\begin{enumerate}
\item Id.
\item See Vinzant, \textit{supra} note 112, at H01; see also Joseph McLaughlin, \textit{The Changing Role of the Securities Analyst in Initial Public Offerings}, 8 INSIGHTS 6 (1994).
\item See McCune, \textit{supra} note 56, at 23.
\item See McLaughlin, \textit{supra} note 231, at 7.
\item See id.
\item See id.; see also Hovarth, \textit{supra} note 43, at 6.
\item See Testimony by Dalmon Silvers, Associate General Counsel of the AFL-CIO Before the House Financial Services Committee Subcommittee on Capital Markets, Insurance and Government-Sponsored Enterprises Hearing on Financial Market Analysis Accuracy, FDCH CONG. TESTIMONY, June 14, 2001; see also Testimony of David W. Tice, Portfolio Manager of Prudent Bear Fund and Publisher of the Institutional Research Service "Behind the Numbers" Before the House Financial Services Committee Subcommittee on Capital Markets,
banks seeking to mend fences with company executives often pressure or even fire the analysts responsible for negative ratings. Moreover, an investment bank can earn higher profits if analysts whip up the intense demand that, when coupled with a constricted supply, generates hot IPOs.

During the Internet boom, according to certain experts some analysts behaved like nothing more than glorified salespeople for their firms' offerings. In 2000, investors who followed the advice of analysts employed by investment banks that underwrote the recommended stocks, lost an average of 52% of their investments. That compares to a loss of only four percent over the same period, for those investors who followed the recommendations of analysts working at research-only firms.

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238. See Gretchen Morgenson, How Did So Many Get it So Wrong, N.Y. TIMES, Dec. 31, 2000 at C1 (quoting Mitch Zacks of Zacks Investment Research as saying "the way an analyst can get fired is to damage an existing investment banking relationship with a company or sour a future investment banking relationship. The way you do that as an analyst is coming out and telling people to sell a stock.").

239. See Vinzant, supra note 112, at H01.

240. See, e.g., Peter Elkind, Where Mary Meeker Went Wrong; She May Be the Greatest Dealmaker Around. The Problem Is, She's Supposed to Be an Analyst, FORTUNE, May 14, 2001, at 68 (discussing the track record of Mary Meeker, "the unquestioned diva of the Internet Age," who was paid an eye-popping $15 million in 1999 to analyze companies that had underwriting relationships with Meeker's employer, Morgan Stanley); see also Marilyn Geewax, Congress Warns Stock Analysts May Face Regulation, COX NEWS SERV. (June 14, 2001), (quoting Financial Services Committee Chairman Representative Michael Oxley, R-Ohio as saying, "I'm distressed by the statistic that as the markets were crashing last year, less than 2 percent of analyst recommendations were to sell. Analysts are so important to the marketplace that the last thing we need is the perception that they're nothing more than hucksters."). See generally, Wall Street's Conflicted Research, N.Y. TIMES, June 15, 2001, at 38. (reporting on the June 12, 2001 issuance of voluntary guidelines from the Securities Industry Association designed to encourage greater independence of analysts' research from the investment banking operations at their firms).


242. See id.
A. The "Chinese Wall"

Millions of people who bought into the dot-com frenzy understandably feel resentful toward celebrity Wall Street analysts who, relying on innovative valuation criteria, kept pumping out "buy" recommendations on high-flying stock prices that had reached untenable levels. Given the potential for conflicts of interest, a "Chinese Wall" has traditionally separated a firm's securities analysts from its investment banking department, to preserve market integrity.

"Information is the lifeblood of [the] securities market." Misinformation by financial analysts can render dysfunctional the market pricing mechanism that determines which industries receive precious resources, thus undermining the foundation of capitalism. Wall Street analysts shoot themselves in the foot if their research is perceived as biased, as they quickly lose their investors' trust. However, the credibility that analysts already enjoy with the investing public may be subject to abuse when

243. See Wall Street's Conflicted Research, supra note 240, at A38.
244. See McLaughlin, supra note 231, at 6 (concluding that an analyst is not "tainted" when brought "over the wall" if the analyst's role is clearly disclosed to the issuer); see also Toedtman, supra note 2, at A63 (noting that at the House Financial Services subcommittee hearing on June 14, 2001, the industry was criticized for apparent conflicts of interest and urged to rebuild the "Chinese Wall").
247. See The Analyst Paradox: If They're so Plagued with Conflicts, Why Do They Do Such a Good Job?: Hearing on Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street? Before the House Subcomm. On Capital Markets, Insurance and Government-Sponsored Enterprises, FDCH CONG. TESTIMONY, (June 14, 2001) (statement of James K. Glassman, Resident Fellow, American Enterprise Institute) (arguing that conflicts of interest are not a big problem because analysts' reports are closely followed under the "full glare of publicity.").
248. See McLaughlin, supra note 231, at 7 (noting that while earning estimates from investment bankers may be regarded as "tainted," an analyst's estimates
they fail to disclose underwriting agreements between their employers and the companies they review. Indeed, the "Chinese Wall" separating research and underwriting is not just the result of good practice and industry self-regulation. Rather, investment bankers need the separation to avoid legal pitfalls.

1. Legal Requirements and Regulatory Pitfalls

a.) Gun-Jumping and Conditioning the Market

The involvement of analysts in the underwriting effort puts the issuer and the investment bank in a delicate regulatory position. The Second Circuit Court of Appeals has described the relationship between an issuer and its analyst as a form of "corporate brinkmanship" and a "fencing match conducted on a tightrope." Moreover, the SEC has actively sought to "electrify" this tightrope.

will have greater credibility with salespeople and customers).

249. See id.; see also Carol Vinzant, Merrill Alters Guidelines for Analysts, WASH. POST, June 19, 2001, at E01 (stating that Merrill Lynch & Co. will begin disclosing its potential corporate conflicts of interests on the front of analyst reports in bold lettering rather then small type at the back of the report); Carol Vinzant, Wall Street Group Issues Analysts' Code, WASH. POST, June 13, 2001, at E01 (reporting that the Securities Industry Association voluntary guidelines, issued on June 12, 2001, encourage analysts to disclose which companies are also investment banking clients of their firm).

250. See McLaughlin, supra note 231, at 7.

251. See id.

252. See Elkind v. Liggett & Myers, Inc., 635 F.2d 156, 158 (2d Cir. 1980) (referring to the disclosure of nonpublic, business related information to analysts).

253. See SEC v. Bausch & Lomb, Inc., 565 F.2d 8, 9 (2d Cir. 1977) (describing corporate executives as being "... compelled to parry often incisive questioning [from an analyst] while teetering on the fine line between data properly conveyed and material inside information that may not be revealed without simultaneously releasing it to the public.").

As discussed above, Section 5(c) of the Securities Act makes it unlawful to offer to sell a security unless a registration statement has been filed.\textsuperscript{255} Under Section 5(b), a security may be legally offered after the filing of the registration statement but before it has been declared effective, provided that the prospectus used for this purpose contains the information specified in Section 10 of the Securities Act.\textsuperscript{256} In general, after the filing but before the registration statement has been declared effective, only a statutory prospectus may be offered.\textsuperscript{257}

An analyst, however, routinely publishes business evaluations of companies that may be preparing for an offering. According to the SEC, these reports “may in fact contribute to conditioning the public mind or arousing public interest in the company or in the securities of a company in a manner which raises a serious question whether the publicity is not in fact part of the selling effort.”\textsuperscript{258}

b.) Insider Trading

An analyst who goes “over the wall” to the underwriting side of investment banking should consider the potential for exposure to insider trading liability. In particular, analysts often rely on “material nonpublic information” to prepare a report on the issuer released twenty-five days after the IPO.\textsuperscript{259} The report will contain earning projections based on the nonpublic information.\textsuperscript{260}

However, an analyst may not downgrade or upgrade an issuer’s

\begin{footnotesize}
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\item Institute, University of California, San Diego (Jan. 24, 1991)).
\item 255. 15 U.S.C. § 77e(c) (2000).
\item 256. 15 U.S.C. § 77e(b) (2000). As discussed below, the term “prospectus” as used in the securities laws is a term of art that includes “any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security.” 15 U.S.C. § 77b(10) (2000). A Section 10 prospectus is a prospectus containing certain specified information, including information regarding the issuer’s business, assets, and financial condition. 15 U.S.C. § 77j (2000).
\item 257. See 15 U.S.C. § 77j.
\item 258. Publication of Information Prior to or After the Effective Date of a Registration Statement, Securities Act Release No. 33,3844, 22 F.R. 8359 (Oct. 8, 1957).
\item 259. See McLaughlin, supra note 231, at 7.
\item 260. Id.
\end{itemize}
\end{footnotesize}
stock on the basis of this “nonpublic” information.261

1.) Dirks v. SEC

In Dirks v. SEC, the Supreme Court introduced a standard for insider trading liability that requires the receipt of a direct or indirect pecuniary benefit by the tipper.262 Raymond Dirks, a financial analyst and officer of a broker-dealer firm, uncovered a massive fraud after receiving a tip from an insider at Equity Funding, an insurance company that he regularly followed.263 Fraudulent corporate practices caused the company’s assets to be greatly overstated.264 The Court determined that Dirks’ tipper had received no direct or indirect personal benefit from tipping, but had instead been prompted by a desire to uncover and “air out” the fraud.265 The case also involved an appeal of a censure by the SEC against Dirks.

Dirks verified the fraud by interviewing some Equity Funding employees.266 He then sought to publicly disclose the fraud by contacting a reporter from the Wall Street Journal, yet the reporter declined to write the story out of fear of a libel charge.267 During this time, Dirks remained in contact with a number of clients and investors, including five investment advisers who liquidated a total of more than $16 million in Equity Funding’s stock, driving down the price from $26 to less than $15.268 For such limited disclosures, the SEC censured Dirks.269

Citing Chiarella v. United States, the Supreme Court reversed the SEC’s censure, reasoning that Dirks owed no fiduciary duty to Equity Funding shareholders and had not misappropriated any information.270 In Chiarella, the Supreme Court stated that liability

261. See id.
263. Id. at 648-49.
264. Id.
265. Id. at 667.
266. Id. at 649.
267. Id. at 649-50.
268. Id. at 650.
269. Id. at 652.
270. Id. at 665, 667.
for insider trading can only attach where a relationship of trust and confidence exists between the person who exploits the inside information and the shareholders of the company. Dirks was not an officer, director, or controlling shareholder of Equity Funding and consequently did not violate §10(b) of the Securities Act by “remaining silent” with respect to other market participants (i.e., by failing to disclose) when his clients traded on the material information.

Dirks reiterated the principles developed in Chiarella. In particular, the Court explicitly rejected the view that a breach of fiduciary duty occurs whenever inside information is intentionally disclosed to securities traders. Under Chiarella, there is no general duty to ignore selectively disclosed information, nor to forego market transactions “based on material, nonpublic information.”

Dirks supplements the Chiarella standard for determining liability for insider trading. Specifically, “the test is whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach

272. See Dirks, 463 U.S. at 651. Section 10(b) of the Exchange Act of 1934 prohibits the use “in connection with the purchase or sale of any security... [of] any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe.” 15 U.S.C. § 78j (2000). Pursuant to this section, the SEC promulgated Rule 10-b5, which in relevant part provides that –

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

273. See Dirks, 463 U.S. at 667.
274. See id.
of duty to stockholders.\textsuperscript{276} Moreover, the Court emphasized in \textit{Dirks} that the benefit received must approximate "[a] pecuniary gain or reputational benefit that will translate into future earnings."\textsuperscript{277} Because the insider from whom Dirks had received the tip did not directly or indirectly benefit from tipping, the censure of Dirks by the SEC could not stand.\textsuperscript{278}

It is worth noting that under \textit{Chiarella}, an analyst who, for the benefit of his employer, exploits privileged information obtained in the course of an underwriting, could be found guilty of insider trading. An analyst may not misappropriate information to which he had access only for another, narrow, purpose.\textsuperscript{279} An analyst who passes any of that information to his employer's institutional clients has breached his employer's fiduciary duties towards the underwriting candidate.\textsuperscript{280} Under \textit{Dirks}, the benefit to the analyst and his employer has to be direct and tangible, such as larger year-end bonuses and other pecuniary compensation for the analyst, and higher trading revenues and other "kickbacks" from institutional clients for the employer.\textsuperscript{281}

A failure to preserve the "Chinese Wall" between the research and underwriting aspects of investment banking could give rise to insider trading liability, particularly in light of the SEC's narrow reading of key Supreme Court rulings. Indeed, there is no sign of

\begin{footnotesize}
277. \textit{Id.} at 663.
278. \textit{See id.} at 667.
279. The Supreme Court further developed the misappropriation theory of insider trading in \textit{Carpenter v. United States}, 484 U.S. 19 (1987). In that case, a reporter and an associate working for the \textit{Wall Street Journal} were convicted of wire fraud because they had traded on information that belonged to their employer, namely information to be published on the "Heard on the Street" column, which the reporter co-authored. \textit{See id.} at 23, 28. The Supreme Court affirmed the conviction. \textit{See id.} at 28. The Supreme Court expressly endorsed the misappropriation theory of insider trading in \textit{United States v. O'Hagan}; that case involved an attorney trading in the securities of a target company in a tender offer, where the attorney's law firm represented the bidder. \textit{United States v. O'Hagan}, 521 U.S. 642 (1997).
\end{footnotesize}
the SEC backing away from its restrictive interpretation of the Supreme Court's potentially industry-friendly precedents.  

Currently, the SEC vigorously criticizes companies that have favored securities analysts or institutional investors with information that is more timely or extensive than that available to the general public.  

2.) SEC v. Stevens

Slowly but surely, the SEC has sought to chip away at the protections against insider trading liability in *Dirks* and *Chiarella*. In *SEC v. Stevens*, the Commission alleged that Phillip J. Stevens, former C.E.O. and Chairman of Ultrasystems Corporation, sought to protect his professional reputation by selectively disclosing material information to securities analysts.  

In 1984, following unexpectedly negative quarterly earnings results, an analyst had publicly challenged Stevens' representations regarding the corporation's financial figures.  

The SEC alleged that Stevens perceived this challenge as injurious to his reputation as a manager.  

Accordingly, in 1987, when it became clear that revenues for the first quarter of 1988 would be significantly lower

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285. See id. at *2.

286. See id.
than anticipated, Stevens attempted to prevent another incident like that of 1984.\textsuperscript{287} He placed a number of unsolicited calls to several securities analysts, "recklessly disclosing" material information that had not yet been made publicly available "in order to protect and enhance his reputation."\textsuperscript{288} This represented a direct, tangible benefit to Stevens' status as a corporate manager and to his continued earning power as a chief executive, thus satisfying Supreme Court standards for insider trading.\textsuperscript{289}

The information that Stevens had selectively disclosed was released to the public on the very same afternoon that Stevens made his disclosures. Nonetheless, by then two of the securities analysts contacted by Stevens had already tipped off their clients, who promptly dumped their stock.\textsuperscript{290} Stevens consented to an injunction against future violations of Sections 17(a) of the Securities Act and 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), as well as to an order requiring him to pay $126,455, "the amount of losses avoided by those shareholders who received material nonpublic information concerning Ultrasystem's expected first quarter earnings, and who sold Ultrasystems' stock prior to the public announcement of Ultrasystems' anticipated results."\textsuperscript{291} Stevens marked a victory for those who advocate equality or parity of information among all market participants.\textsuperscript{292}

Other commentators, however, have charged that by equating selective disclosure with securities fraud, Stevens is built on a dubious theory that "trivializes" Dirks and shrinks it "from a landmark decision to the status of a legal footnote."\textsuperscript{293} Indeed, it is not altogether clear that Stevens and Dirks can be reconciled. Although Stevens was never litigated, the "reputational" benefit alleged by the SEC is probably too vague to satisfy the liability

\textsuperscript{287} See id.

\textsuperscript{288} Id.

\textsuperscript{289} See id. at *2-3.


\textsuperscript{291} Id. at *1.

\textsuperscript{292} See Dean Foust, \textit{The Do's and Don'ts of Feeding Wall Street Analysts}, Bus. Wk., Apr. 8, 1991, at 27.

\textsuperscript{293} Coffee, \textit{The SEC and the Securities Analyst, supra} note 282, at 5; see also Schneider, \textit{supra} note 254.
standards under *Dirks*. After all, a tipper’s desire “to protect and enhance his reputation” is a very weak standard.\(^{294}\) It would probably be satisfied in all cases of selective disclosure that are not wholly unintentional where the tipper has not received a bribe or other pecuniary benefit or himself traded on the material information, as required by *Dirks*.\(^{295}\)

c.) Regulation FD

The SEC would eventually seek to avoid the *Dirks* “personal benefit” test by invoking its authority to set disclosure standards under §§13(a) and 15(d) of the Exchange Act, as well as § 30 of the Investment Company Act of 1940 (“Investment Company Act”).\(^{296}\) Regulation FD sidesteps Supreme Court precedent and clarifies the legal status of individuals who pass tips to analysts and other insiders but who do not derive personal pecuniary benefit from the tip.\(^{297}\) The requirements imposed by Regulation FD are twofold.\(^{298}\) First, Regulation FD addresses the manner in which disclosures of material nonpublic information must be made.\(^{299}\) In particular, an issuer that intends to disclose material nonpublic information must do so through public disclosure, and not through selective disclosure to analysts, institutional investors or others.\(^{300}\) Under Rule 100(a)(1), Regulation FD requires that an issuer who “intentionally” discloses material nonpublic information to a selected party must simultaneously disclose that same information to the investing public as a whole.\(^{301}\) An intentional disclosure

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\(^{295}\) See id.

\(^{296}\) Regulation FD, supra note 136, 17 C.F.R. §§ 243.100-03 (2001). Specifically, in adopting Regulation FD, the SEC invoked its authority under the following provisions of the securities laws: 15 U.S.C. §§ 78c, 78i, 78m, 78o, 78w, 78mm and 80a-2. See id.


\(^{298}\) See Sokolow & O’Brien, supra note 283, at S8.


\(^{300}\) See id.

\(^{301}\) Rule 100(a) provides in full –
occurs when the individual making the disclosure knows or recklessly disregards knowledge prior to the disclosure that the disclosure involves material nonpublic information.  

The second requirement of Regulation FD addresses corrective action in the event of selective disclosure. An issuer who learns about a non-intentional disclosure must disclose to the market as a whole the information that was accidentally revealed. Specifically, Rule 100(a)(2) requires that public disclosure must be made "promptly," a term narrowly defined to mean as soon as reasonably practicable, but in no event later than twenty-four hours after a senior official of the issuer learns about the non-intentional disclosure.  

Regulation FD also describes how public disclosure must be carried out. Filing a Form 8-K with the SEC describing the relevant information will fulfill the public disclosure requirements. Alternatively, an issuer may disseminate the information by a press release through a widely circulated news or wire service, or by "any other method of disclosure that is reasonably designed to provide broad public access to the
information and does not exclude any members of the public from access.307

1.) The Parity of Information Theory

Regulation FD specifically provides that a failure to make the required public disclosures shall not be deemed a violation of Rule 10b-5.308 However, Regulation FD reinstates, albeit under the threat of less severe penalties, the parity of information theory initially rejected under Rule 10b-5 by the Supreme Court.309 The SEC justified Regulation FD on the basis of fundamental fairness.310

Regulation FD was also designed to prevent the use of material nonpublic information as a commodity with which companies reward particular analysts or favored investors.311 Former SEC Chairman Arthur Levitt described the behind-the-scenes feeding of material information from companies to favored individuals as a “stain on our markets.”312 As discussed above, the SEC is entirely aware of the conflict of interest plaguing analysts working for investment banks.313 In the absence of a prohibition on

307. See id. and accompanying text. For example, allowing the public unrestricted opportunities for personal attendance at a press conference where the material nonpublic information is initially released would satisfy the public disclosure requirements. Attendance by the public through electronic transmission would also be acceptable. See id.
308. See Regulation FD, supra note 136; see also 17 C.F.R. § 243.102 (2001).
309. See Karmel, supra note 127, at 3.
313. See, e.g., Jeffrey M. Laderman, Who Can You Trust? Wall Street’s Spin
selective disclosure, analysts may feel pressured to exercise self-censorship or otherwise slant their views in favor of the companies that they review.\textsuperscript{314}

2.) Rule 10b5-1

Invoking its rulemaking authority under §10 of the Exchange Act, the SEC adopted two other insider trading rules to complement Regulation FD.\textsuperscript{315} The first such rule is Rule 10b5-1, which provides for a Chinese Wall defense for insider trading violations.\textsuperscript{316} Under Rule 10b5-1, a person only incurs liability for insider trading when he purchases or sells securities while aware of material nonpublic information.\textsuperscript{317} In other words, lack of knowledge is a defense.\textsuperscript{318}

Rule 10b5-1 clarifies an uncertainty in the law. According to the Supreme Court, liability for insider trading may attach against an individual who trades “on” or “on the basis of” material nonpublic information.\textsuperscript{319} However, the Supreme Court has not determined whether the “use” of such information in trading decisions is required for liability to attach, or whether “knowing possession” while trading is enough.\textsuperscript{320}

Rule 10b5-1 resolved the conflict among the circuits by bluntly defining “trading on the basis of” material nonpublic information as “knowing possession.”\textsuperscript{321} In other words, only an investment

\textsuperscript{314} See id. (indicating that self-censorship would detrimentally “chill corporate communication”).


\textsuperscript{316} See Karmel, supra note 127, at 3.


\textsuperscript{318} See Karmel, supra note 127, at 3.


\textsuperscript{320} See Karmel, supra note 127, at 3.

\textsuperscript{321} 17 C.F.R. § 243.101-03 (2001); see also Practising Law Institute, 1204 PLI/CorP. 113 (2000). For a discussion on the controversy over the terms “use” and “knowing possession”, see generally, L. Briley Brisendine, Securities Regulation, 52 Mercer L. Rev. 1507 (2001). The most controversial circuit cases were United States v. Smith, 155 F.3d 1051 (9th Cir. 1998), United States v. Teicher, 987 F.2d 112, 119 (2d Cir. 1993), and SEC v. Adler, 137 F.3d 1325 (11th
bank that maintains a Chinese Wall between the research and underwriting aspects of its business will be able to avoid liability for insider trading should its analysts trade or advise clients to trade in the stock of companies it underwrites. By clarifying the impact of the “knowing possession” of insider information, Rule 10b5-1 promotes analyst independence.

The second rule that the SEC adopted to complement Regulation FD is Rule 10b5-2, which addresses the issue of tipping of family members and other non-business associates by insiders. For purposes of establishing liability under the misappropriation theory of insider trading, a breach of a duty of confidence or trust must exist whenever: 1) the recipient agrees to maintain information in confidence; 2) the recipient knows or should know that confidentiality is expected from the history, pattern or practice of sharing confidences between the recipient and the person communicating the information; or 3) the recipient obtained the information from a child, spouse, or sibling, unless it can be proved that no duty or expectation of confidence existed.

3. Regulation FD in Practice

Prior to its adoption, Regulation FD was the subject of intense debate. Its opponents argued that the regulation’s impact would be to “chill” corporate disclosures by stemming the free flow of information to analysts. Today, analysts are generally unhappy with Regulation FD because it undercuts their influence. The Security Industry Association claims that, as anticipated, Regulation FD is “chilling the flow of information” to analysts by eliminating the once-routine practice of companies giving special

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322. See id. It should be noted that Rule 10b5-2 is less important for the purposes of this Article than Rule 10b5-1 and is only mentioned for the sake of thoroughness.


325. See Robert Dietrich, Analysts "Hamstrung" by SEC Disclosure Rule: Companies Simply Disclosing Less to Everyone, NAT'L POST, June 1, 2001, at D01.
briefings to brokerage firms. Moreover, Regulation FD allegedly costs companies upwards of $300 million a year in compliance costs.

On the other hand, advocates of small investors describe Regulation FD as a "smashing success," warning that "you'll have people with pitchforks in the streets" if the SEC tries to overturn or weaken it. According to a "recent survey [by the] National Investor Relations Institute . . . 28% of its member companies were providing more information to analysts and investors after [the regulation was issued than before]." Moreover, an additional 48% have not cut back on the amount of information they provide. Likewise, a survey by PricewaterhouseCoopers of 160 publicly traded companies revealed that "many [were] disclosing . . . more frequently [after Regulation FD and] that few had incurred significant compliance costs.

The most profound impact of Regulation FD may be on Wall Street culture and attitudes towards small investors. For the foreseeable future, small investors will continue to be excluded from road shows because, as discussed above, regular securities offerings are typically conducted in tandem with Rule 144A and other restricted offerings. However, Regulation FD opens the doors for small investors to certain forums from which they have historically been excluded. For example, in 1999, "more than seventy-five percent of companies that held earnings conference calls [with analysts] excluded individual investors." Today, as a result of Regulation FD, individual investors have access to virtually all such conference calls.

327. See Dietrich, supra note 325, at D01.
328. See id. (quoting John Markese, president of the American Association of Individual Investors); see also Christopher H. Schmitt, Fair Disclosure is Better than Advertised, BUS. WK., May 7, 2001, at 66.
329. See Schmitt, supra note 328.
330. See id.
331. See id.
332. See id.
333. See id.
B. Analyst Bias & The Internet Bust

Analysts are supposed to be experts at channeling scarce capital into the most promising companies. During the Internet boom, however, analysts' reports were no longer the dry documents, rich in accounting data and small type, of yesteryear. Instead, they often bore the breezy, salesman-like appearance of get-rich-quick-scheme advertisements.

For the year 2000, analysts' stock-picking performances were generally miserable. A recent study that examined 168,281 ratings from analysts in 213 financial firms found that highly recommended stocks under-performed the market by 31%, while the least recommended stocks outperformed the market by 49%. Moreover, even as Internet stock values were imploding, a survey by Thomson Financial found that during December 2000, 71% of all analyst recommendations were “buy,” 27% were “hold,” and only 2% were “sell.”

Indeed, the new economy broke all rules of traditional finance. Companies went public with no dividends or promise of dividends, no profits, and even sometimes without revenue projections.

334. See Elstrom, supra note 2, at EB16 (discussing the abandonment by financial firms of proven investment strategies during the Internet boom).
335. See Tully, Betrayal on Wall Street, supra note 18 (describing the Internet boom as a con game); see also Rhonda Schaffler, Market Call: Tough Call: Ethical Practice of Wall Street Analysts under Congressional Scrutiny (CNNF broadcast, June 15, 2001) (interview with financial writer Benjamin Mark Cole discussing recent Congressional hearings, the conflicts of interest inherent in financial analysts' recommendations, and the need for reform). In one commentator's words, “[t]he Chinese wall that once separated investment banking from research is deadier than the Berlin Wall right now.” Matthew Benjamin, Financial Advice you Can Trust, U.S. NEWS & WORLD REP., June 25, 2001, at 36 (discussing the lack of objective information available to investors from analysts and the need for reform).
336. See Breaking Point for U.S. Brokers, AUSTRALIAN FIN. REV., June 19, 2001, at 62 (discussing how conflicts of interest led to poor stock picking performance and the industry's attempt at self regulation in the face of Congressional hearings).
337. Id.
338. Toedtman, supra note 2, at A63; see also Testimony by Dalmon Silvers, supra note 237.
339. See Michael Loh, Why Did Dotcoms Crash?, BUS. TIMES SINGAPORE,
During the boom, investors prodded by Wall Street forecasts, dangerously equated the theoretical possibilities of new technologies with the real-world math of financial markets. On December 16, 1998, an analyst at CIBC Oppenheimer predicted that the shares of Amazon.com, then at $242.75, would reach $400 within a year. At the time, Amazon.com was losing ninety cents a share, and had never turned a profit. Nonetheless, the price of Amazon.com stock shot up $46.25 in a single day on the strength of that announcement, and traded at a split-adjusted price of nearly $600 one year later.

At its highest valuation in the spring of 1999, Amazon.com was valued at an astounding $33 billion. To put this in perspective, Amazon.com, which in 1999 lost $720 million from $1.6 billion in revenues, was worth approximately as much as General Motors, which that year earned $5.6 billion in profits from $176.5 billion in revenues. To reach that valuation, Amazon.com's share price appreciated more than 4,000% since its IPO in May 1997. Assuming a somewhat generous price/earnings multiple of twenty, Amazon.com's peak valuation would have normally been justified for a company with net yearly profits in excess of $1.5 billion, not for a business that was producing greater losses each quarter.


340. See Lewitt, supra note 1, at 41 (describing the valuation theories employed to value Internet companies as flawed).
342. Id.
343. Id.
346. See also Bethany McLean, Introducing the FORTUNE Stock Indexes; The Fortune 500 Index and the Fortune e-50 Index Represent the Size, Strength, and Amazing Inventiveness of American Business, FORTUNE, Mar. 6, 2000, at 130.
348. Lewitt, supra note 1, at 41 n.11.
1. The "New" Economy

As discussed above, some type of valuation method is necessary to get at least an initial estimate of the price at which IPO shares should be offered. A stock’s price is generally a function of current earnings and anticipated growth of future earnings. Most Internet companies, however, exhibited zero or negative earnings when they sought a first round of financing from Wall Street. Moreover, growth of earnings is usually estimated with reference to the industry as a whole. Internet companies, however, were pioneering a relatively novel technology, with no industry track record against which to estimate earnings.

Technology experts soon stepped in to offer their advice on the subject of valuation. For “new economy” theorists in Wall Street and Silicon Valley, the Internet was so revolutionary it justified the suspension of the traditional rules of corporate finance. Due to the “network effect,” the “law of accelerating returns,” and the “microcosm” nature of the Internet, the

349. McCarthy, supra note 138.
350. See id.
351. See id.
352. See id.
353. See Lewitt, supra note 1, at 41.
354. “The network effect holds that the value of a single component of a network (like a fax machine or a PC) increases with the number of components in the network.” Id. For example, a PC-compatible computer is more valuable than a non-PC compatible computer because there are more PC-compatible computers than non-PC compatible computers. See id. Therefore, PC-compatible computers can communicate with more computers and have access to a wider diversity of software and services than non-PC compatible computers. See id.
355. Ray Kurzweil explains “the law of accelerating returns” as follows –
Technology is the continuation of evolution by other means, and is itself an evolutionary process. So it, too, speeds up. A primary reason that evolution – of life-forms or of technology – speeds up is that it builds on its own increasing order... the evolutionary process of technology seeks to improve capabilities in an exponential fashion. Innovation is multiplicative, not additive. Technology, like any evolutionary process, builds on itself.
356. According to George Gilder, “In the microcosm, the cost of fuel and materials declines drastically; the expense devolves from matter to mind. Just as
possibilities for profit from investing in Internet-related companies were boundless.\textsuperscript{357}

Furthermore, deepening losses should not distract investors from focusing on market share. According to W. Brian Arthur, a leading technology expert –

\begin{quote}
Not only do the costs of producing high-technology products fall as a company makes more of them, but the benefits of using them increase. Many items such as computers or telecommunications equipment work in networks that require compatibility; when one brand gains a significant market share, people have a strong incentive to buy more of the same product so as to be able to exchange information with those using it already.\textsuperscript{358}
\end{quote}

It followed that marketing expenses of any magnitude were justified. Some theorists went so far as to claim that the New Economy was immune from the traditional boom-bust rules of economic gravity. New Economy guru Kevin Kelly, in his book \textit{The New Rules for the New Economy}, described the coming Internet Age as follows –

\begin{quote}
Communications is the foundation of society, of our culture, of our humanity, of our individual identity, and of all economic systems. This is why networks are such a big deal. Communication is so close to culture and society itself that the effects of technologizing it are beyond the scale of mere industrial-sector cycle. Communication, and its ally computers, is a special case in economic history. Not because it happens to be the fashionable leading business sector of our day, but because its cultural, technological, and conceptual impacts reverberate at the root of our lives.\textsuperscript{359}
\end{quote}

\textsuperscript{357} Quantum science overthrew Newtonian matter in the explanation of the universe, the quantum economy overthrows Newtonian matter in the creation of wealth.” GEORGE GILDER, MICRO COSM: THE QUANTUM REVOLUTION IN ECONOMICS AND TECHNOLOGY 30 (1989).

\textsuperscript{358} See id.

\textsuperscript{359} W. BRIAN ARTHUR, INCREASING RETURNS AND PATH DEPENDENCY IN THE ECONOMY 3-4 (1994).

\textsuperscript{359} KEVIN KELLY, NEW RULES FOR THE NEW ECONOMY: 10 RADICAL STRATEGIES FOR A CONNECTED WORLD 5 (1998).
The traditional rules for determining the price of the stock of a company would have vetted financing for many Internet upstarts. Instead of discriminating between upstarts, Wall Street engaged in the wholesale adoption of new and unproven valuation models. Losses were disregarded, and analysts instead focused on revenue growth, industry leadership, and projected profitability to establish pricing benchmarks. Some Wall Street analysts adopted even more dubious valuation methods based on hazy and empirically unsupported concepts such as "multiples of revenue," "scalability," or "visibility." Inflated and unreliable revenue and cash flow projections were extrapolated up to the sky based on elegant, absurd, or entirely optimistic theories.

a. Boo.com

One of the most memorable business failures of the Internet boom involves Boo.com and its attempt to become the world's premier Internet fashion-retailer, as well as "the first truly global e-tailer, with world-wide sales, marketing and distribution capabilities." To this end, Boo.com used a three dimensional, graphics-intensive website with a virtual changing room that allowed customers to virtually "try on" clothes and view them from every angle. The site conducted business in seven languages and quoted prices in eighteen currencies. However, it took the company an entire five months after having already begun an intensive advertising campaign to finally launch its website, and when it was finally launched, it was riddled with many glitches and

360. See McCarthy, supra note 138.
361. See Lewitt, supra note 1, at 41.
362. See id.
364. See Christopher Cooper & Erik Portanger, Spooked: Money Men Liked Boo and Boo Liked Money; Then It All Went Poof; Flashy Web Site for Clothes Had Lots of Cool Ideas, Few Financial Controls, WALL ST. J., June 27, 2000, at A1.
365. Id.
complicated technical difficulties, making it practically unusable.\textsuperscript{366}

In a period of only eighteen months, Boo managed to burn through $185 million in venture capital financing.\textsuperscript{367} Investment banks such as Goldman Sachs and J.P. Morgan had raised much of that money from private investors, and additional funding was expected.\textsuperscript{366} However, before J.P. Morgan could launch the planned IPO, Boo had become the object of media ridicule and was hopelessly insolvent.\textsuperscript{369}

All losses considered, Boo blew a cool $200 million in only one and a half years.\textsuperscript{370} Where did so much money go so quickly? A lot of money went into advertising. For instance, in 1999, Boo hired a prestigious London ad agency and projected a two-year $65 million advertising budget.\textsuperscript{371} Boo also spent lavishly on parties and employee perks, such as five-star hotels and first class travel to attend fashion shows in Paris and Milan.\textsuperscript{372} Almost overnight the staff ballooned from five to two hundred.\textsuperscript{373} Despite such considerable marketing expenditures, Boo was only able to generate a paltry $380,000 in revenues during its first operating quarter.\textsuperscript{374} In a desperate attempt to move inventory, Boo

\begin{footnotesize}
\begin{enumerate}
\item[366.] See Erik Portanger & Stephanie Gruner, \textit{Boo.com to Move into Receivership as Funds Dry Up}, WALL ST. J., May 18, 2000, at B16; see also Cate T. Corcoran, \textit{More than Style}, WALL ST. J., Apr. 17, 2000, at R68.
\item[368.] See Cooper & Portanger, supra note 365, at A1.
\item[369.] Id.; see also, e.g., Paul Kedroisky, supra note 367, at D11; \textit{It's Strategy; What's Dumb Is Dumb, No Matter How Much Technology It Uses}, FIN. DIRECTOR, Oct. 19, 2000, at 53.
\item[372.] See Karlion Lillington, \textit{Dust Settles on Dot.com Hype, Venture Capitalists and Investors Have Become More Cautious Amid High-Profile Failures}, IRISH TIMES, June 2, 2000, at 59; see also Cooper & Portanger, supra note 365, at A1.
\item[373.] Sorkin, supra note 367, at 3.
\item[374.] Kerry Capell, \textit{Boo.com Is Getting Downright Scary}, BUS. WK., May 22,
discounted its merchandise by 40% or more. At the Boo.com liquidation sale, an online-shopping portal paid about $400,000 for Boo.com’s domain names, trademarks, and other assets (including the special Boo font, 40,000 giveaway Boo Frisbees, as well as Boo’s sexy digital mascot, Miss Boo). Another company snapped up its software and ninety technology employees for $378,000.

b. Pets.com

Pets.com, Inc is another much-celebrated casualty of the Internet bust. Pointedly, pet supplies have never been a particularly lucrative business, with razor-thin margins of around 2%. Moreover, bags of dog food are heavy, and cannot be delivered to customers cheaply. Indeed, the larger Pets.com revenues grew, the more money it lost.

2000, at 22.

375. Id.


378. Although over 130 dot-coms folded in 2000, the failure of Pets.com was one of the more memorable – and not just because of its famous Sock Puppet mascot, a floppy-eared dog with a spot over one eye featured in many TV commercials. See Pui-Wing Tam & Mylene Mangalindan, Pet-Supply Site Sought Money but Couldn’t Find Backers; ‘It’s Sad,’ Says the Founder, WALL ST. J., Nov. 8, 2000, at B1; see also Katharine Mieszkowski, The Glory Days of E-Commerce Are Over, SALON.COM, Nov. 29, 2000, available at http://www.salon.com/tech/feature/2000/11/29/ecommerce/index.html (last visited Jan. 23, 2002).


380. See id.

381. In fact, the business plan of Pets.com has been variously described as “dumb” or “stupid,” with one commentator suggesting that it would have been a good thing if “Fido had just chewed it up from the start.” See Michael Liedtke, Dot.coms Can Provide Some Dumb Ideas, CHATTANOOGA TIMES, Dec. 24, 2000, at G2; see also Weintraub & Hof, supra note 379, at 78 (noting that the company was not making a profit); cf. Mieszkowski, supra note 378 (describing dot-com business plans as “stupid”).
Pets.com started operations in February 1999. By the end of 1999, the company had $5.8 million in sales, having spent $55.3 million to sell goods costing the company $13.4 million, as it sought to “increase market share” (as its offering prospectus delicately put it). Pet.com’s dismal track record did not discourage Merrill Lynch from taking the company public. The February 2000 IPO raised an additional $66 million for Pets.com. Ten months later, the company closed its doors.

In its brief eighteen-month existence, Pets.com accumulated $147 million in losses. Shortly before the company finally shut down, its stock stood at twenty-two cents a share, a long way down from its $11 offering price or the $14 price the stock reached shortly after its first day of trading. Analysts for Merrill Lynch, however, had gleefully pumped up the stock throughout its downward trajectory. Henry Blodget, “Wall Street’s loudest cheerleader of Internet stocks” and an analyst with Merrill Lynch at the time, issued a buy recommendation when the stock hit $16. When the stock fell to $7, Blodget reaffirmed his buy rating, and again when the stock dropped to $2, and then again when it dropped to $1.69. When the stock hit $1.43, Blodget told investors to “accumulate.” Henry Blodget has since become the...

385. Elstrom, supra note 2, at EB16.
386. Id.
388. Id.; see also Tam & Mangalindan, supra note 378, at B1.
389. Kurtz, supra note 384, at C01 (explaining that while Henry Blodget was virtually canonized during the dot-com boom, he is now one of many analysts to be vilified for the Internet stocks’ downfall).
391. Id.
392. Id.
target of lawsuits by disgruntled investors.\(^{393}\)

**C. A New Wall for Wall Street**

Under both NYSE and NASD rules, reports issued by analysts during or shortly after a public offering must disclose any involvement of the analyst’s employer in the offering as an underwriter.\(^{394}\) However, under the Supreme Court’s decision in *Virginia Bankshares, Inc. v. Sandberg*, a simple failure to disclose bias or motivation may be insufficient to support a cause of action under Rule 10b-5.\(^{395}\) As mentioned above, however, the SEC has broad powers to issue disclosure rules. The SEC could, for example, amend Regulation FD to require analysts to disclose potential bias.

Indeed, the financial services industry is under intense pressure to take preventive action and forestall the recurrence of certain practices common during the Internet boom. “Less than 48 hours before [congressional] hearings, the Securities Industry Association and 14 major investment banks recently [took a stab at self-regulation by issuing] a list of *Best Practices for Research.*”\(^{396}\) The main thrust of that publication involves rules that bar researchers from reporting to bankers, analysts from trading against their stock recommendations, and banks from tying compensation to specific deals.\(^{397}\) According to the Best Practices report, analysts should always exhibit objective and independent judgment, and should promote the best interests of investors,

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394. See McLaughlin, *supra* note 231.


397. See *id.*
rather than IPO candidates.\textsuperscript{398} Importantly, the Best Practices report calls for analysts to disclose involvement by their employer in IPOs of the companies that they cover.\textsuperscript{399} By its nature, unfortunately, the guidelines of the Best Practices report are exhortative rather than mandatory.\textsuperscript{400}

IV. THE MUTUAL FUND INDUSTRY AND THE IPO ALLOCATION RULES

A. The GLG Partners and Chelsey Capital Investigation

Analyst independence created problems during the Internet boom that cannot be properly appreciated without discussing IPO allocation. As previously discussed, analysts employed overoptimistic IPO forecasts to inflate the demand for stocks of questionable value. Then, prior to the public offering, underwriters gave blocks of intentionally underrated stock to favored clients. These shares experienced a predictable pop on the first day of trading, and the clients, usually institutional investors such as mutual funds, flipped them for quick profit. The client then gave a "kickback" to the underwriter by doing more trading business with the underwriter's bank, which increased the bank's lucrative trading revenues.

In an all too typical kind case, the SEC is investigating two little-known mutual funds, GLG Partners ("GLG") and Chelsey Capital ("Chelsey"), for receiving oversized IPO allocations of shares of VA Linux Systems.\textsuperscript{401} The shares went public at $30 and closed that same day at $239.25, for an almost immediate 697.5% gain for those individuals or institutions fortunate enough to have

\begin{itemize}
  \item \textsuperscript{398} See id. (stating that with respect to conflict of interest, "research employees should always put customer interests ahead of personal investments").
  \item \textsuperscript{399} See id. (noting that when a firm takes a company public and a member of the firm's analyst team has a stake in the company, that fact should be disclosed).
  \item \textsuperscript{400} See id.
  \item \textsuperscript{401} Randall Smith, \textit{SEC Probes Two Funds' Role in IPO Stakes}, WALL ST. J., Jan. 8, 2001, at C1 (detailing the SEC investigation into Wall Street firms that received high trading commissions in exchange for doling out "slices of coveted IPOs.").
\end{itemize}
been allocated shares in the IPO by its underwriter. In exchange for the coveted IPO shares, GLG and Chelsey may have paid kickbacks in the form of unusually large trading commissions to Credit Suisse First Boston ("CSFB"), which underwrote the VA Linux offering.

GLG and Chelsey received 35,000 shares and 15,000 shares, respectively, and earned profits of $7.3 million and $3.1 million respectively by flipping the shares the first day of trading. Over the next few days, the mutual funds engaged CSFB to handle enormous trades in unrelated securities, with commission rates of "20 times the going rate for institutional investors." An internal investigation at CSFB revealed that some of its brokers might have pressured the mutual funds into paying the excessive commissions in exchange for an allocation of the IPO shares. CSFB fired three brokers, all of whom were supervised by Frank Quattrone. Quattrone is the famed securities analyst and investment banker with a $100 million-a-year compensation package who had a key role in launching many of the Internet IPOs in the 1990s.

During the Internet boom, CSFB underwrote 186 IPOs, more than any other investment bank in the world. However,

402. Id.
403. Id.
404. Id. By contrast, “some of the largest mutual fund groups in the U.S.”, whose assets significantly exceed those of the two mutual funds involved in the probe, such as Alliance Capital Management and AIM Management Group, received comparatively paltry allocations of between 60,000 and 75,000 shares. See id.
405. Id.
407. Id.
408. Matt Beer, Lawmen Pick Through Dot.com Wreckage for Wrongdoing, AGENCE FRANCE PRESSE, May 9, 2001 (noting that in addition, Frank Quattrone was under an SEC probe for illegal IPO related activities); see also Duncan Hughes, Buy or Sell? Just Ignore the "Experts," SUNDAY BUS., May 6, 2001, at 16 (stating that Quattrone and his fellow “independent” analysts have recently come under fire from critics for having a cozy relationship with their investment banking colleagues and the companies they were taking to the market).
twenty-five of the companies CSFB brought public, representing $133.8 million in revenues for the bank, traded for less than $1 per share as of April 2001.410 Yet, CSFB analysts continued to release optimistic recommendations.411 For the first quarter of 2001, the forty stocks with “buy” recommendations from CSFB analysts showed a net loss, compared to a modest 14% return for those stocks with “sell” recommendations.412

The VA Linux incident may cost CSFB and those individuals involved dearly. According to a class action filed by small investors, “Credit Suisse solicited and received additional, excessive and undisclosed commissions from certain investors, in exchange for which it allocated to those investors material portions of the restricted number of Linux shares issued in connection with the offering.”413 This was a violation of the terms of the offering prospectus and there is a possibility of criminal charges.414 The SEC has added eight attorneys to its Silicon Valley staff.415 The U.S. Attorney’s Office has added seven attorneys to its securities fraud unit in Silicon Valley, up from zero in 1999.416 As one Silicon Valley gossip columnist quipped, “[f]or me, the high-tech beat is now a crime beat.”417

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410. Id.
411. See Hughes, supra note 408, at 16 (noting that investment banks continue to recommend Internet stocks such as Yahoo! and Amazon.com despite huge falls in the prices of both stocks).
412. Id. As previously discussed, the disparity between analyst recommendations and stock performance is not unique to CSFB. For example, investors who had followed each of the seven “strong buy” recommendations issued by Morgan Stanley Dean Witter Internet analysts in early 2000 would have watched their portfolio implode with 100% losses. See Hughes, supra note 408, at 16.
414. See id. (stating that in addition to possible criminal charges, and SEC inquiries, the NASD is also questioning several of Quattrone’s colleagues).
415. Beer, supra note 408.
416. Id.
417. Id.
B. IPO Allocation Rules

Institutional investors are intermediaries between the issuer and long-term investors — they routinely flip their IPO allocations soon after the offering, imposing an added cost and an unnecessary burden on the capital formation system. Nonetheless, the IPO allocation rules focus less on inefficiency and waste than on the gross unfairness of who is receiving a hot IPO. However, the rules do not require that hot IPOs be allocated equitably or on a first-come, first-serve basis.

1. The NASD Free-Riding and Withholding Interpretation

The NASD requires members to observe, in the conduct of their business, “high standards of commercial honor and just and equitable principles of trade.” Accordingly, the NASD has long prohibited NASD members and their affiliated persons from participating in hot IPOs. The applicable NASD standard is the “Free-Riding and Withholding” Interpretation (the “Interpretation”), which is based on the premise that underwriters have an ethical obligation to make a bona fide distribution of

418. See Coffee, The IPO Allocation Probe: Who Is the Victim?, supra note 14, at 6. Because institutional investors regularly ‘flip’ the shares they buy in IPOs within days or weeks of the offering, they are as much a link in the transmission pipeline between the issuer and the ultimate long-term investor as is the underwriter. See id. Hence, to this extent, underpricing typically benefits neither the issuer nor the long-term investor, but is rather a cost imposed on capital formation, which accrues to financial intermediaries. See id.

419. See id.

420. See id.


422. See Coffee, The IPO Allocation Probe: Who Is the Victim?, supra note 14, at 6, n.4 (“The NASD has long had a policy restricting the sale by NASD members of securities in public offerings to accounts in which ‘restricted persons’ have a beneficial interest.”).
public offerings trading at a premium. Under the Interpretation, hot IPOs include any securities offering that trades at a premium in the aftermarket, regardless of magnitude. No sales of such securities may be made to "any officer, director, general partner, employee or agent of the member or any other broker/dealer, or to a member of the immediate family of any such person." Moreover, the underwriter and members of the underwriting team not registered with NASD may not retain hot IPO shares in their personal accounts.

The Interpretation also prevents an investment bank from turning allocations of hot IPOs into bribes to improve future underwriting or trading revenues for the investment bank. It also prohibits allocations to so-called finders, or individuals whose professional duties give them enhanced access to young companies on the verge of going public. Likewise, allocations of hot IPOs to individuals who manage large blocks of stocks for third parties, and who may be expected to regularly direct large-volume trades, are also prohibited.

Section 15A of the Exchange Act, authorizes the NASD to promulgate rules to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest. These rules can be enforced by penalties that range from limitation of NASD related

423. See NASD Free Riding and Withholding Interpretation, supra note 162, at IM-2110-1.
424. See id. at IM-2110-1(a).
425. Id. at IM-2110-1(b)(2).
426. See id. at IM-2110-1(b)(1).
427. See id.
428. See id. at IM-2110-1(b)(3).
429. See id. at IM-2110-1(b)(4).
(6) The rules of the association [must be] designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest . . . .
activities to expulsion\textsuperscript{431}.

The Interpretation is an interpretation of NASD Conduct Rule 2110 and simply states, "[a] member . . . shall observe high standards of commercial honor and just and equitable principles of trade."\textsuperscript{432} The NASD recently filed a proposal with the SEC to make this interpretation a rule. This rule should raise the profile of the NASD's position on the subject of improper IPO allocation.\textsuperscript{433}

2. Proposed NASD Rule 2790

In fall 1999, the NASD presented Rule 2790, a new rule proposal to replace the Free-Riding and Withholding Interpretation.\textsuperscript{434} The new rule should facilitate enforcement by releasing from supervision certain activities that posed only minor regulatory concerns.\textsuperscript{435} On the other hand, some of the changes that the new rule introduces are not so welcome.

Rule 2790 will continue to prohibit the practice of allocating IPO units as a "reward" to individuals in a position to direct future business to a member firm.\textsuperscript{436} However, unlike its predecessor,

\textsuperscript{431} Specifically, Section 15A(b)(b)(7) of the Exchange Act provides –

(7) The rules of the association [must] provide that (subject to any rule or order of the Commission pursuant to section 17(d) or 19(g)(2) of this title [15 U.S.C. §§ 78q(d), 78s(g)(2)] its members and persons associated with its members shall be appropriately disciplined for violation of any provision of this title, the rules or regulations thereunder, the rules of the Municipal Securities Rulemaking Board, or the rules of the association, by expulsion, suspension, limitation of activities, functions, and operations, fine, censure, being suspended or barred from being associated with a member, or any other fitting sanction.

Id.


\textsuperscript{436} See Notice of Filing of Proposed Rule Change by the National
Rule 2790 is purportedly designed to deter some of the chicanery that took place during the Internet boom. In general, the latest amended version of Rule 2790 provides that –

(1) A member or a person associated with a member may not sell, or cause to [sell,] be sold, a [hot] new issue [in a public offering] to any account in which a restricted person [or a member of the restricted person’s immediate family] has a beneficial interest, except as otherwise permitted herein [or through an exemption pursuant to the Rule 9600 Series].

(2) A member or a person associated with a member may not purchase a [hot issues acquired in a public offering except as permitted herein or through an exception pursuant to the Rule 9600 Series. [sic]] new issue in any account in which such a member or person associate [sic] with a member has a beneficial interest, except as otherwise permitted herein.

(3) A member may not continue to hold [hot issues acquired in a public offering except as permitted herein or through an exception pursuant to the Rule 9600 Series. [sic]] new issues acquired by the member as an underwriter, selling group member, or otherwise, except as otherwise permitted herein.

A key distinction between the Interpretation and Rule 2790 is in their scopes. The Interpretation covers hot issues, which are defined as new issues that experience an aftermarket premium, regardless of that premium’s magnitude. By contrast, Rule 2790 eliminates the notion of hot issues. It covers all new issues (i.e.,

437. See Siconolfi, supra note 28, at C16.
439. See Hensley & Endres, supra note 433, (noting that the proposed amendment applies to most initial equity public offerings, not just to the “hot” issues).
most IPOs of equity securities), not just hot issues.440

Rule 2790 affords broker-dealers with greater certainty of compliance in structuring their IPO allocations.441 Under the Interpretation, a broker-dealer has to cancel any sales to a restricted person prior to the first business day if an offering unexpectedly trades at a premium in the aftermarket.442 Rule 2790 would place a blanket restriction on holdings of new issue securities by broker-dealers or their associated persons in any account in which they may have a beneficial ownership interest.443 The Interpretation contains a comparable restriction.444 However, Rule 2790 introduces new record keeping requirements that would allow broker-dealers to certify that they have not sold any new issues to a restricted person.445 As a precondition to sale, the broker-dealer must obtain a representation from the prospective customer that no restricted person has a beneficial interest in the account into which a new issue will be sold.446 These representations must be updated at least annually.447

Another difference is the broader definition of “beneficial interest” in Rule 2790. The Interpretation contains a relatively narrow definition of beneficial interest. Conversely, Rule 2790 applies to “any economic interest,” whether direct or indirect, including the right to share in collective gains or losses.448 The proposed rule also carves out an exemption for management fees (also known as performance fees), based on operating a collective investment account.449 As discussed below, the restrictions in Rule 2790 generally do not apply to allocations to investment funds. Although allocations to investment fund managers in their

440. See Rule 2790 Amendment No. 2, supra note 438, at 76,316.
441. See Hensley & Endres, supra note 433.
442. See NASD Free Riding and Withholding Interpretation, supra note 162, at IM-2110-1(a)(3).
443. See Hensley & Endres, supra note 433.
444. NASD Free Riding and Withholding Interpretation, supra note 162, at IM-2110-1(a)(1).
445. See Rule 2790 Amendment No. 2, supra note 438, at 76,316.
446. See id.
447. Hensley & Endres, supra note 433.
448. See Rule 2790 Amendment No. 2, supra note 438, at 76,316.
449. Id.
personal capacity are banned, allocations to the investment funds that they manage are unrestricted under the exemption.

Nonetheless, in regards to deterring abuses of the IPO allocation process, the management or performance fees exemption seems improper. The soaring valuations of dot-com stocks during the Internet boom had a direct effect on Wall Street compensation, boosting salaries across the board. Yet, most of the increases took the shape of annual bonuses — which rewarded robust underwriting and trading revenues, as well as inflated short-term market valuations. For example, the typical managing director made $2 million in 2000, with a base salary of only $200,000 to $250,000.

Under the proposed rule, an allocation of a substantial block of hot IPO units to an investment fund can directly affect the compensation level of the fund’s manager and employees. The management and performance fees exemption to Rule 2790 thereby undermines the statutory restrictions and reinforces the potential impact of hot IPO allocations as a commercial bribe.

Another problem with Rule 2790 is that it narrows the definition of a restricted person. As currently drafted, Rule 2790 would apply uniformly to all broker-dealers, including foreign (“other”) broker-dealers. Yet at the same time, the proposed rule only restricts IPO allocations to “portfolio” managers, or personnel who have “the authority to make investment decisions.” This restriction seems to disregard the pressures on a portfolio manager by a financial institution.

Rule 2790 also continues the policies of the Interpretation with respect to institutional buyers. IPO allocation restrictions under Rule 2790 do not expressly apply to investment companies registered under the Investment Company Act, collective

450. See Michael McDonald, Pay Envelopes Swell for Execs, Managers; Benefits, Perks Also on the Rise; Hourly Workers Not Faring as Well, CRAIN'S N.Y. BUS., Aug. 28, 2000, at 3.
451. See id.
452. See id.
453. See Hensley & Endres, supra note 433.
454. See Rule 2790 Amendment No. 2, supra note 438, at 76,318-19.
455. See id. at 76,319.
456. See Hensley & Endres, supra note 433.
investment accounts involving one thousand or more trust accounts or policyholders, or publicly traded corporations. The rationale seems to be that IPO allocations made to these investment vehicles ultimately reach the public because they are open to public participation. However, as discussed above, the IPO allocation problem is not just one of fairness, but of the efficiency with which our capital markets operate.

Institutional buyers are key to the success of an IPO. Potentially, institutional buyers have the resources to purchase large blocks of stock and maintain an orderly secondary market. However, IPO allocation mechanisms could be devised to preserve the participation of institutional buyers in IPOs without injuring the efficiency of the capital markets. Rule 2790 could require that underwriters allocate scarce IPO units pro rata, according to the value of market orders.

For example, assume that there are one hundred IPO units, and that individuals A, B, and C and institutional investor XYZ place market orders for one hundred, two hundred, three hundred, and one thousand units respectively. There are a total of 1,600 market orders for an IPO that only consists of one hundred units; the IPO is oversubscribed by a ratio of 16:1. A pro rata allocation would entitle A to 6.25, or $\frac{100\times100}{1600}$ units (assuming that fractional shares are possible). Similarly, B would receive 12.5 units, while C would receive 18.75 units and XYZ would receive 62.5 units. Mandatory pro rata allocation of new issues has the advantage of reducing the incentives an underwriter has to purposely under-price IPOs.

As an alternative, IPOs could be distributed according to the Dutch auction system. Under that system, an oversubscribed stock would go to the highest bidder, and not to the underwriter’s preferred customer. This approach, pioneered by W. R.

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457. See Rule 2790 Amendment No. 2, supra note 438, at 76,317.
458. See Coffee, ‘Spinning’ for Dollars, supra note 27.
459. See McCune, supra note 56, at 23 (“The success of an IPO stems from the number of large institutional investors that buy in.”).
460. See Coffee, IPO Underpricing and Dutch Auctions, supra note 158 (positing that “[i]n an efficient, frictionless world...[i]ssuers would turn to a Dutch Auction format to sell their stock to the highest bidder”).
461. See id.
Hambrecht & Co., would create "greater value for the issuer while also chilling the incentive" to under-price the IPO or to "flip" shares in the aftermarket.\footnote{Id.}

Different variations of a Dutch auction system could be established. For example, Hambrecht's "openIPO" system sells to bidders, or the highest bidders, of the shares requested, but at the price of the lowest bid accepted.\footnote{See id.} The "openIPO" system protects the issuer against under-pricing, and also protects the highest bidder against the "winner's curse."\footnote{Id.} That curse, common to straight Dutch auctions, affects the highest bidder — he "is the one most likely to have overvalued the auctioned asset," relative to other participants in a competitive market.\footnote{Id.}

Another flaw in Rule 2790 relates to a policy inherited, in part, from the Interpretation.\footnote{See Hensley & Endres, supra note 433.} The proposed rule places no restrictions on the issuer directing new issue placements to selected persons, including friends and family, unless such person is an employee or director of the issuer, its parent or its subsidiary.\footnote{See Rule 2790 Amendment No.2, supra note 438, at 76,318.} However, issuer-directed sales to broker dealers would continue to be prohibited.\footnote{See id.} The proposed rule would allow the issuer to distribute IPOs on a pro rata, "equal opportunity" basis to at least 10,000 people, a disproportionate number of which cannot be restricted persons.\footnote{Id. at 76,317.}

The overall impact of the issuer-directed sales exemption is to neatly align the interests of the issuer's management and directors with those of the underwriter and its institutional clients. As discussed above, a hot IPO means that the issuer has not raised as much money as it otherwise could from the public offering, and the rights of prior stakeholders have been diluted. However, the issuer will not pressure the underwriter into conducting the offer at a proper price, because the issuer's management and directors stand
to personally profit from a hot IPO.

Despite its shortcomings, Rule 2790 includes certain changes that liberalize the rule’s enforcement without jeopardizing its effectiveness. For example, the proposed rule will only be applicable to equity offerings.470 The rule will not apply to convertible securities; exempted securities (as defined in §3(a)(12) of the Exchange Act); preferred securities; investment grade asset-backed securities (as defined in SEC Form S-3); closed-end investment company securities (as defined under §5(a)(2) of the Investment Company Act); and “rights, offerings, exchange offers, and offerings made pursuant to a merger or acquisition.”471

Additionally, the proposed rule exempts all debt securities from new issue restrictions, regardless of their investment grade, as well as secondary offerings of actively traded securities.472 The latter types of offerings are difficult to purposely under-price, due to the market impact. Similarly, existing market prices already provide a clear and definite pricing benchmark for actively traded securities. Debt securities are tied primarily to interest rates, and thus are not influenced by market demand. They also attract very little retail interest.

Finally, some aspects of Rule 2790 reflect compromises with everyday business practicality. In particular, Rule 2790 eases restrictions on under-subscribed issues.473 Because Rule 2790 covers new issues and not just hot (i.e., oversubscribed) issues, it expressly provides that an underwriter, pursuant to an underwriting agreement, may place a portion of the offering on its own accounts when it is unable to sell that portion to the public.474

470. Hensley & Endres, supra note 433.
471. Rule 2790 Amendment No. 2, supra note 438, at 76,318.
472. See Rule 2790 Amendment No. 1, supra note 436, at 2659; Rule 2790 Amendment No. 2, supra note 438, at 76,318 (discussing of the rationales for the exemptions in question). Historically, the NASD has exempted most, but not all, investment grade asset backed securities from hot issue restrictions. See NASD Rule on Trading in Hot Equity Offerings, supra note 435.
473. See Hensley & Endres, supra note 433. Rule 2790 would allow an underwriter to place shares of an under subscribed IPO in their account when it is unable to sell that portion to the public. Id.
474. See Rule 2790 Amendment No. 2, supra note 438, at 76,318.
C. IPO Allocations Secured through Kickbacks

Under current IPO allocation rules, the underwriter's discretion in distributing IPOs remains virtually unrestricted. However, IPO allocations secured through kickbacks to the underwriter in the form of increased trading revenues or outsized commissions are particularly shocking to the SEC. Although the problem is not specifically addressed by any particular statute or regulation, there are several liability theories that may apply, some of them derived from criminal law.

1. Liability for Mail and Wire Fraud

Under 18 U.S.C. § 1346 a “scheme or artifice to deprive another of the intangible right of honest services” is a “scheme to defraud” within the meaning of the federal mail and wire fraud statutes. Moreover, a scheme to deprive another of intangible services could potentially trigger liability under the Racketeering Influenced and Corrupt Organizations Act (“RICO”) because mail and wire fraud is a predicate offense under that statute. A RICO violation is punishable by up to twenty years in prison or by stiff fines including confiscation of the assets of the business or company involved, or by both.

A conviction for mail and wire fraud over a deprivation of

honest services requires that the government prove the existence of a duty to provide such honest services.\textsuperscript{479} Generally, a duty to provide honest services would exist in a fiduciary relationship.\textsuperscript{480}

An underwriter could raise at least two defenses against a charge brought under 18 U.S.C. §1346.\textsuperscript{481} First, it could argue that its relationship with a corporation represented by a sophisticated securities counsel cannot be characterized as fiduciary.\textsuperscript{482} Secondly, it could also argue that establishing the price of securities during a public offering involves arms-length bargaining that is outside of the scope of fiduciary duties.\textsuperscript{483}

In some jurisdictions, courts have explicitly described the relationship between an underwriter and an issuer as being such that fiduciary obligations may arise under some circumstances.\textsuperscript{484} In \textit{In re Daisy Systems Corp.}, the Court ruled that Bear Stearns & Co. owed a duty to its underwriting client, Daisy Systems.\textsuperscript{485} According to the Ninth Circuit, even though Daisy Systems was a sophisticated corporate client, it was "unschooled in the niceties of public acquisitions."\textsuperscript{486} Hence, whether the requisite "superiority" implicit in a fiduciary duty could have existed was a question for a jury to decide.\textsuperscript{487}

In the Second Circuit case of \textit{United States v. Chestman}, it was held that "[a] fiduciary relationship involves discretionary authority and dependency."\textsuperscript{488} In the absence of discretionary authority and dependency, influence may suffice.\textsuperscript{489} The relationship between an underwriter and an issuer can easily meet this relatively low threshold for the existence of a fiduciary duty.

\textsuperscript{479} See United States v. Gray, 790 F.2d 1290, 1296 (6th Cir. 1986).
\textsuperscript{480} Id.
\textsuperscript{481} Coffee, \textit{The IPO Allocation Probe: Who Is the Victim?}, \textit{supra} note 14, at 6 ("At least two defenses exist to [the] 'intangible rights' theory.").
\textsuperscript{482} Id.
\textsuperscript{483} Id.
\textsuperscript{484} See \textit{id.} (stating that "authority exists that an investment banking firm can owe a fiduciary duty to a sophisticated public corporation . . . .").
\textsuperscript{485} In \textit{re Daisy Sys. Corp.}, 97 F.3d 1171 (9th Cir. 1996).
\textsuperscript{486} Id. at 1178
\textsuperscript{487} See \textit{id.}
\textsuperscript{488} United States v. Chestman, 947 F.2d 551, 569 (2d Cir. 1991).
\textsuperscript{489} See \textit{id.}
This would particularly be the case if the underwriter induced the issuer's executives to award themselves hot IPOs. On the other hand, the underwriter could argue that even if dependency, influence, and discretionary authority existed with respect to certain aspects of the relationship, they did not exist as far as pricing decisions were concerned. As with Daisy Systems, the Chestman standards for a fiduciary relationship require a fact-specific analysis by the jury.

2. Rule 10b-5

The government could also address hot IPO abuses by assessing liability under Rule 10b-5. For example, the government could allege that the underwriter failed to disclose its true underwriting compensation in the prospectus. According to the SEC, undisclosed mark-ups over 10% are presumptively fraudulent. In essence, the government would argue that the undisclosed brokerage commissions represented illegal "kickbacks." Unfortunately, the cases targeted by the SEC for excessive mark-ups typically involve "widows and orphans," not sophisticated and well-advised corporations.

Another problem with utilizing the Rule 10b-5 theory is that the institutional investor paying the excessive commissions is

490. See Coffee, The IPO Allocation Probe: Who Is the Victim?, supra note 14, at 6 (arguing that "even if the underwriter is a fiduciary to the issuer . . . the issuer client may either understand that pricing is outside that relationship as an inherently arms-length negotiation, or may consent, possibly implicitly, to underpricing as a means of hyping the stock price.").
491. See id.
492. See id.
494. See Charles Hughes & Co. v. SEC, 139 F.2d 434, 437 (2d Cir. 1943).
probably doing so voluntarily. A complicating factor involves the “indirect” character of the quid pro quo potentially involved. The underwriter may allocate hot IPOs to a valued client to preserve goodwill. Correspondingly, the institutional client may engage in excessive trading, with the implicit assumption that the resulting good relations with the underwriter will increase the likelihood of generous allocations of hot IPOs in the future. The absence of a specific regulatory ban by either the NASD or the SEC against favoritism in IPO allocations makes a criminal case against the industry an uphill, although not impossible, battle.

VI. HOT IPOs & THE MUTUAL FUND MANAGER

A. Section 17 of the Investment Company Act

As previously discussed, it is a violation of the NASD’s Free-Riding and Withholding Interpretation for the underwriter to allocate hot IPOs to a manager of an investment company. However, under Section 17 of the Investment Company Act of 1940, the manager is also barred from “accepting” the hot IPO.

496. See Coffee, The IPO Allocation Probe: Who Is the Victim?, supra note 14, at 6 (acknowledging that “this theory is harder to maintain when the client is a sophisticated hedge fund that may have offered to pay such a fee with its eyes wide open.”).
497. See id.
498. Id. (speaking of the “possibility that the hedge fund paid the excess brokerage rate not for a specific transaction, but to earn the underwriter’s general good will and obtain eventual allocations in multiple transactions. In contrast, a bribe usually involves a specific quid pro quo exchange.”).
499. See id.
500. See id.
501. See 15 U.S.C. § 80a-17 (2000). According to SEC Commissioner Robert Healey’s testimony during the Investment Company Act enactment hearings, Section 17 says that “you cannot sit on both sides of the table when you are dealing with an investment trust.” Investment Company Act of 1940; Hearings on S. 3580, Before a Subcommittee of the Senate Committee on Banking & Currency, 76th Cong., 37 (1940) [hereinafter, Commissioner Healey’s Testimony].
The purpose of Section 17(d) of the Investment Company Act is to prevent insider abuse. 502

The transactions covered under Section 17(d) and its surrogate Rule 17(d)-1 involve any joint arrangement in which an affiliate 503 of an investment company and the investment company sit on the same side of the table during a business transaction. 504 Commissioner Healey illustrated the type of abuse that Section 17(d) was designed to address –

Investment companies have been compelled to finance banking clients of the insiders, and companies in which they were personally interested. Some investment companies are organized to be operated essentially as discretionary brokerage accounts, with the insiders obtaining the brokerage commissions. In many instances the abuses are more subtle but just as injurious to the investor. The public's funds are used to 502


"Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

Id.

504. See Bartlett & Dowd, supra note 502, at 450-53. By contrast, earlier sections are more specific. For example, Section 17(a) is applicable only to sales, purchases, or loans conducted directly between an investment company and its affiliate, as parties sitting on the opposite sides of the table. The loose contours of Section 17(d) presumably reflect an intent to address those activities not described in the earlier subsections. Consider the full text of 15 U.S.C. § 80a-17(a) (2000).
further the banking business of the insiders to obtain control of various industrial enterprises, banks and insurance companies, so that the emoluments of this control will flow to these controlling persons.\textsuperscript{505}

Notably, Section 17(d) does not make any specific conduct unlawful.\textsuperscript{506} Rather, rules subsequently promulgated by the SEC determine what types of conduct constitute a violation.

The strength of Section 17(d) is Rule 17d-1.\textsuperscript{507} Rule 17d-1(a) prohibits any joint arrangements or enterprises between investment companies and affiliated persons absent prior SEC authorization.\textsuperscript{508} Rule 17d-1(a) outlines regulation by exemption, wherein the absence of an exemption entails an absolute ban on a relevant activity.\textsuperscript{509} However, none of the Rule 17d-1 exemptions is applicable to the hot IPO phenomenon.\textsuperscript{510} Therefore, whenever an affiliate and an investment company sit on the same side of the table and conduct a business transaction with a third party, approval must be secured in advance from the SEC or the transaction is disallowed.\textsuperscript{511}

In the following case, although the SEC chose not to pursue a violation of Rule 17d-1 (alleging instead breaches of a number of other rules and statutory provisions), a breach of Rule 17d-1 would have provided a solid basis for an enforcement action.

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B. In re Monetta Financial Services, Inc.

In re Monetta Financial Services, Inc. involved a "hot issue" allocation scheme — the mutual fund would increase its brokerage activity with the underwriters, in exchange for two Monetta mutual funds directors' personal receipt of hot offerings. The directors quickly flipped the hot issues, earning tens of thousands of dollars in profits. The directors had not disclosed the allocation to the funds' shareholders. They had also failed to obtain the consent of disinterested representatives of the funds for the transaction. In other words, the fund and its affiliates had entered into a profit-sharing enterprise without seeking prior SEC approval.

The SEC focused on the directors' failure to disclose the transaction. Because the IPO allocations "created serious conflicts of interest for [the directors] in their review of the funds' operations, the allocations constituted material information that was relevant to the operation of the [funds]." The Commission therefore alleged violations of §17(a) of the Securities Act, as well as §10(b) of the Exchange Act and Rule 10b-5.

VII. CONCLUSION

The current statutory and regulatory framework is inadequate to address the hot IPO phenomenon or to prevent its possible recurrence. The SEC should invoke its rulemaking powers to strengthen disclosures of analyst conflicts of interest and potential bias. Moreover, IPO allocation rules should be redrafted to prevent favoritism. In particular, restrictions should be placed on allocations to institutional investors and issuer-directed persons.

513. Id. at *9.
514. Id. at *10.
515. Id. at *11.
516. Id.
517. See id.
518. Id. at *12-*13.
519. See id.; see also 15 U.S.C. § 77q (2000), also known as §17(a) of the Securities Act of 1933.
This would deter underwriters from purposefully under-pricing IPOs with the implicit consent of the issuer’s management or directors. In addition, such regulatory changes would also increase the efficiency of capital markets. Finally, underwriters should be required to distribute IPOs on either a pro rata or Dutch auction basis; this could be accomplished either by SEC action or internal NASD requirements.