The Dutch Auction Myth

Peter B. Oh
THE DUTCH AUCTION MYTH

Peter B. Oh†

42 WAKE FOREST L. REV. (forthcoming 2007)

ABSTRACT

The bursting of the internet bubble continues to have ripple effects on the initial public offering (IPO) process. Critics of this process have fashioned a complex set of interconnected objections to the orthodox bookbuilding method for conducting IPOs, pricing shares, and allocating them to preferred investors. Critics instead hail online reverse-bid, or Dutch, auctions (Dutch IPOs) as an alternative method promising more equitable access, efficient prices, and egalitarian allocations.

This article comprehensively assesses the case for Dutch IPOs. Part I dissects critiques of bookbuilding, which rely on anomalous data, derogate established financial literature, and largely evaporate in the face of recent regulations. Part II examines the empirical performance of Dutch IPOs, which have failed to distinguish themselves in the United States and around the world. Part III reveals ways in which Dutch IPOs may be susceptible to fraud and manipulation that bookbuilding is not. Ultimately, claims of the Dutch IPO's superiority over bookbuilding are unproven at best and at worst fail to appreciate certain risks.

JEL Classifications: C70, D21, D44, D82, E22, G24, K22, K42, M14.

† Associate Professor of Law, University of Pittsburgh School of Law. B.A. 1994, Yale College; J.D. 1997, The University of Chicago. E-mail: poh@pitt.edu. I thank Anita Indira Anand, Steven A. Bank, Lisa Bernstein, Russell L. Christopher, George S. Geis, Sean J. Griffith, Shmuel Hauser, Raleigh Hannah Levine, Gregory Mitchell, Steven A. Ramirez, Niels B. Schaumann, and Dale B. Thompson for their comments and suggestions. I also thank participants from the Annual Meeting of the Midwestern Law & Economics, the Legal Scholarship Workshop at The University of Chicago Law School, and a Faculty Workshop at the University of Tulsa College of Law. And I am grateful to W.R. Hambrecht + Co. and Jay R. Ritter, who served as a consultant to Google’s IPO, for sharing valuable data.
TABLE OF CONTENTS

INTRODUCTION ..........................................................................................3

I. INITIAL PUBLIC OFFERINGS ....................................................................9
   A. Underpricing Underwriters .................................................................9
      Table 1: U.S. IPO Returns, 1980-2005 ..............................................11
   B. Spinning Bubbles ................................................................................15
      Table 2: Internet Bubble IPO Returns, 1998-2001 .........................19

II. AUCTION-BASED IPOS ..........................................................................21
   A. Domestic Auction-Based IPOs .............................................................21
      Table 3: OpenIPO Data, 1999-2006 ...............................................26
      Table 4A: Mean OpenIPO Returns by Firm Age .........................28
      Table 4B: Mean OpenIPO Returns by Offering Price ..................29
      Table 4C: Mean OpenIPO Returns by Offering Amount .............29
      Table 4D: Mean OpenIPO Returns by Gross Proceeds ...............29
   B. International Auction-Based IPOs ......................................................31
      Table 5: Israeli Auction-Based IPO Returns ..................................32
      Table 6A: French Auction-Based IPO Returns ...............................35
      Table 6B: French Auction v. Bookbuilding IPO Returns ...............36
      Table 6C: French Choice of IPO Method .......................................37

III. SOPHISTICATED AUCTION BEHAVIOR ..............................................38
   A. Manipulative Bidding .........................................................................38
   B. Bidding Rings ....................................................................................42

CONCLUSION ..............................................................................................49
INTRODUCTION

The number of initial public offerings (IPOs) in the United States has increased each and every decade since the 1970s.1 Over the past 26 years domestic IPOs have raised approximately $547 billion,2 while underpricing3 has averaged 17.5%,4 and issuers have left approximately $120 billion on the table.5 These figures, however, pale in comparison to the 1999-2000 internet bubble period, during which mean underpricing skyrocketed to 63.3%,6 and issuers left $62.4 billion on the table.7

When the bubble burst, the hindsight prognosis began. Some cited “widespread and systematic pathologies” within the investment sector as fomenting an IPO frenzy.8 Others pointed to underwriters as orchestrating a “Ponzi Scheme” in which they exchanged services for IPO shares that were then dumped on the investing public.9 Causal explanations aside, the “hyperbolic” increase in IPO underpricing prompted declarations that, “[w]hatever the traditional rationale for underpricing, that rationale no longer applies to current practices.”10

---

1 Jay R. Ritter, Some Factoids About the 2006 IPO Market 2 tbl. 1, 10 tbl. 8 (May 2, 2007), http://bear.cba.ufl.edu/ritter/IPOs2006%20Factoids.pdf. The U.S. share of the global IPO market, however, has been declining. See, e.g., COMMITTEE ON CAPITAL MARKETS REGULATION, INTERIM REPORT OF THE COMMITTEE ON CAPITAL MARKETS REGULATION 2 (2006) (“In the late 1990s, the U.S. exchange listed capital markets were attracting 48 percent of all global IPOs. Since then, the United States has seen its market share of all global IPOs drop to 6 percent . . . .”).

2 Ritter, supra note 1, at 10 tbl. 8.

3 Underpricing refers to the spread between a stock’s initial offering price and closing price after the first-day of trading. See, e.g., Catherine M. Daily et al., IPO Underpricing: A Meta-Analysis and Research Synthesis, 27 ENTREPRENEURSHIP: THEORY & PRACTICE 271, 272 (2003). See also infra note 58.

4 See infra notes 59-62 and accompanying text (Table 1, U.S. IPO Returns, 1980-2005). This article uses data over a 26-year span beginning in 1980, an admittedly arbitrary starting point. While the more logical bookend is September, 1978, when an amended Regulation A increased the registration requirement for IPOs from $500,000 to $1.5 million, most analyses and data sets are limited to post-1980 IPOs.

5 Ritter, supra note 1, at 2. Money left on the table refers to “the difference between the closing price on the first day and the offer price, multiplied by the number of shares sold.” Jay R. Ritter, Money Left on the Table in IPOs by Firm 1 (Jan. 26, 2006), http://bear.cba.ufl.edu/ritter/work_papers/money.pdf.

6 See infra notes 128-129 and accompanying text (Table 2, Internet Bubble IPO Returns, 1998-2001).

Ritter, supra note 1, at 2.

7 Douglas Cumming & Jeffrey MacIntosh, Boom, Bust, and Litigation in Venture Capital Finance, 40 WILLAMETTE L. REV. 867, 868 (2004) (contending “the changing availability of IPOs and greatly enhanced IPO valuations combined to produce widespread and systematic pathologies in IPO exits . . . that led investment bankers and [venture capitalists] to change their behavior in value-destructive ways”).

8 Eliot Spitzer, Keynote Address, 76 ST. JOHN’S L. REV. 801, 811-12 (2002) (“When the analysts and investment bankers went to the CEOs [of issuers] they said . . . ‘you bring your underwriting to us, but we will give you, not the company, but individually IPO allocations to the tune of a few million bucks.’ . . . . They used to have a name for that, a Ponzi Scheme, right?”).

In the bubble’s aftermath the Securities and Exchange Commission (SEC) appointed a blue-ribbon committee to examine the IPO process. That committee, composed of prominent representatives from academic, financial, legal, and securities exchange sectors, noted that “public confidence in the integrity of the IPO process had eroded significantly.”

A contributing factor to this erosion, according to the committee, was “the widespread perception that IPOs are parceled out disproportionately to a few, favored investors, be they large institutions, powerful individuals or ‘friends and family’ of the issuer,” a practice commonly termed spinning.

Among the committee’s recommendations was the development of alternatives to the orthodox bookbuilding method. One alternative is conventionally referred to as the Dutch auction IPO (Dutch IPO). In lieu of meetings and road shows by underwriters to gauge demand from prospective investors, a Dutch IPO conducts price discovery via an auction. Prospective investors bid on their preferred number and price of shares. Successful bids are determined by starting with the highest price and then moving downward until investor demand equals the total amount of securities offered, or clearing price. All shares are awarded at the same final offering price, and excess demand results in a pro rata distribution of shares. The Dutch IPO thus represents an alternate mechanism by which “pricing and allocation are removed from the realm of issuer and underwriter discretion. . . . IPOs conducted through a true auction model should not experience the enormous aftermarket price spikes that fueled the abuses of the bubble period.”

While abstaining from endorsing the Dutch IPO as a replacement for the bookbuilding

---

12 Id. at 1-2.
13 Id. at 2.
14 See, e.g., Sean J. Griffith, Spinning and Underpricing: A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings, 69 Brook. L. Rev. 583, 586 (2004) ("[S]pinning’ refers to the preferential allocation of the right to buy in an IPO."). While Griffith conceives spinning as restricted to only preferential “allocation decisions made by the managing underwriters and other members of the underwriting syndicate,” id. at 586 n.7, spinning also can include preferential allocations to institutional investors, which is the broader conception used here, see infra Part I.B.
15 See infra notes 56-57 and accompanying text.
16 See, e.g., Lucas C. Townsend, Comment, Can Wall Street’s “Global Revolution” Prevent Spinning? A Critical Evaluation of Current Alternatives, 34 Seton Hall L. Rev. 1121, 1163-64 (2004) (“[T]he bid that depletes the shares in the offering . . . determines the ‘clearing price,’ which is the price that the accepted bidders will pay for their shares.”).
17 In theory a pure Dutch IPO the final offering price equals the clearing price. In practice Dutch IPO issuers reserve and exercise the discretion to set a final offering price that deviates from the clearing price. See infra notes 155-159 and accompanying text.
18 IPO Comm., Report, supra note 11, at 9; see also Coffee, supra note 10, at 5 (opining the Dutch IPO is a “logical counter-reaction” to underpricing and spinning).
method, the committee concluded that auctions might be an intriguing way to promote more accurate and transparent IPO pricing.19

The intrigue grabbed Sergey Brin and Larry Page, the iconoclastic co-founders of Google, Inc. (Google). In August, 2004 Wall Street was surprised to learn that the company’s widely-anticipated IPO would be a Dutch auction.20 Brin and Page justified this decision by portraying themselves as sort of corporate Robin Hoods:

It is important to us to have a fair process for our IPO that is inclusive of both small and large investors. It is also crucial that we achieve a good outcome for Google and its current shareholders. This has led us to pursue an auction-based IPO for our entire offering. Our goal is to have a share price that reflects an efficient market valuation of Google that moves rationally based on changes in our business and the stock market.21

Indeed, the co-owners pointed out that: “Buyers hoping to capture profits shortly after our Class A common stock begins trading may be disappointed.”22 A Dutch IPO thus promised to make Google’s IPO more efficient and fair than bookbuilding ever could.

That promise never materialized. Just days before going public, the company intentionally lowered its offering price to generate market enthusiasm for an otherwise sloppily executed IPO.23 While Google’s shares did appreciate by 18.1% on the first-day of trading, that exceeded

---

19 IPO COMM., REPORT, supra note 11, at 3; see also NASD, NASD Approves Rules to Reform IPO Process (Nov. 24, 2003) (encouraging “use of auction systems, such as the Dutch auction system or a similar system to collect indications of interest to help establish the final IPO price”), http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002817. The committee, however, did not regard the Dutch IPO as a way to eliminate abusive allocation practices.

20 Google, however, was not the first firm to conduct a Dutch IPO. See infra note 170 and accompanying text.


22 Google, Inc., Form S-1 Registration Statement 2 http://www.sec.gov/Archives/edgar/data/1288776/000119312504073639/ds1.htm (filed with SEC on Apr. 29, 2004) [hereinafter Google, Form S-1]. A subsequent amendment to the S-1, however, deleted the reference to being “disappointed” and inserted the following language: “The price to the public and allocation of shares will be determined by an auction process. . . . As a result, buyers should not expect to be able to sell their shares for a profit shortly after our Class A common stock begins trading.” Google, Amended Form S-1, supra note 21, at 31 (emphasis added).

23 See infra note 160 and accompanying text.
the mean underpricing for all IPOs that year. Moreover, Google left approximately $300 million at the table and many bidders frustrated with mysteriously low allocations. Accordingly, Google’s experience may be, at best, a cautionary tale of how not to conduct a Dutch IPO, and, at worst, an incomplete catalog of problems that can plague this alternative method.

None of this, however, has deterred support for Dutch IPOs. Scholars instead have stylized Google as a negative case study: Had the Google IPO been viewed as an unambiguous success, there is no doubt that it would have been followed by a flood of additional Dutch auction IPOs. I expect to see noteworthy Dutch auction IPOs executed in the future, though at a slower rate of adoption than if the outcome had been an indisputable triumph. In my opinion, the future use of the Dutch auction for IPOs was never predicated on the success of this particular deal.

Similarly, while conceding that Google “did not unleash the power of a true Dutch auction to create market pricing for the original IPO shares,” others have maintained that, “[w]ithout having Google go public in an alternative universe, critics cannot say decisively that the auction mechanism failed because it underpriced the offering.” The hope, according to these Dutch IPO proponents, is that “powerful issuers such as Google can help force the market for underwriting IPOs adapt to a

---

24 See infra notes 59-62 and accompanying text (Table 1, U.S. IPO Returns, 1980-2005); infra note 154 and accompanying text.
25 See infra notes 56-57 and accompanying text.
26 Laurie Simon Hodrick, Google’s IPO: A Dutch Auction Works, If You Let It, HERMES 1 (Fall 2004). A few months earlier, however, Hodrick evidently saw Google’s IPO quite differently: “Potentially this IPO is incredibly important. . . . If it is deemed a success, it really opens a new avenue for issuing equity.” European Investors Shut Out of Google IPO (Mar. 8, 2004), http://www.dw-world.de/dw/article/0,,1284420,00.html.
27 Christine Hurt, Moral Hazard and the Initial Public Offering, 26 CARDOZO L. REV. 711, 768-69 (2005) [hereinafter Hurt, Moral Hazard]. Hurt likens Google’s auction to “Harry Potter’s mirror at Hogwarts because it shows the observer what the observer wants to see.” Christine Hurt, What Google Can’t Tell Us About Internet Auctions (And What It Can), 37 TOLEDO L. REV. 403, 438 (2006) [hereinafter Hurt, What Google Can’t Tell Us]. Like Hodrick, Hurt believes a silver lining exists within Google’s dark IPO cloud, suggesting that it “will only assist other issuers in negotiating with underwriters for alternative offering mechanisms.” Hurt, Moral Hazard, supra, at 404. The problem is that issuers here and abroad have not rushed to embrace the Dutch IPO, which continues to be offered by only provider in the United States. See infra notes 181-182 and accompanying text (Table 3, OpenIPO Data, 1999-2006); see also infra Part II.
28 Id. at 789. Commentators are divided about whether bookbuilding would have yielded a different result for Google. Compare, e.g., Victor Fleischer, Brand New Deal: The Google IPO and the Branding Effect of Corporate Deal Structures, 103 MICH. L. REV. 1581, 1598-99 (2006) (citing Jim Cramer’s belief that “the offering price would have been higher if Google had done a traditional IPO”), with Hodrick, supra note 26, at 1 (”It is important to note that many of the hurdles faced in the Google IPO would still have been problematic had Google instead chosen to use a standard firm commitment underwriting. . . . These challenges, and not the Dutch auction, were sources of downward pressure on the offer’s demand.”).
more issuer-friendly system,” a “new paradigm” of online IPO auctions to replace traditional bookbuilding.29

The idea, however, is hardly new. Auctions have been used around the world to resolve asymmetrical information problems for thousands of years.30 In 1929 the U.S. Treasury began to experiment with auctioning its own securities.31 Thirty-five years later auction-based IPOs made their debut in France, and since have been entertained by numerous countries in different continents.32 Twenty years ago a student note specifically proposed the idea of U.S. companies conducting Dutch IPOs to eliminate underpricing.33 And that idea struck a favorable note with an SEC Commissioner at the beginning of the internet bubble.34

The formal case for this alternate IPO method rests on three tenets. First, a Dutch IPO represents a more democratic process by providing all investors, individual or institutional, with an opportunity to purchase shares before they debut on the market.35 Second, a Dutch IPO supplies a more equitable method by eliminating preferential allocations and awarding one offering price to all successful bidders.36 And, finally, a

29 Hurt, Moral Hazard, supra note 27, at 789; see also id. at 765 n.300 (citing Carolyn Said, Quattrone’s Trial: A Catalyst for Change, S.F. CHRON., Oct. 26, 2003, at 11 (describing Google’s Dutch auction IPO as reflective of the shift in Silicon Valley to “a new world order” and not the “favoritism and cronism” of 1999)).
32 See infra note 222. See also infra Part II.B.
33 See Katina J. Dorton, Note, Auctioning New Issues of Corporate Securities, 71 VA. L. REV. 1381 (1985). Moreover, public corporations have been conducting stock repurchases via a Dutch auction format for quite some time. See, e.g., Anita I. Anand, Regulating Issuer Bids: The Case of the Dutch Auction, 45 MCGILL L.J. 133, 137 (2000) (“The Dutch Auction is a popular method of share buy-back in the United States. This popularity originated in 1981 when the first Dutch auction was completed in the U.S. by Todd Shipyards.”).
35 See, e.g., Coffee, supra note 10, at 5 (arguing that “individual investors should prefer Dutch Auctions, and a significant ‘democratization’ of the IPO process can be envisioned”); William Hambrecht, Fixing the IPO Process 3 (Sept. 2002) (advocating greater access to all investors through IPOs that “would provide a broader universe of potential buyers” and “create a level playing field to match supply and demand”), http://www.whambrecht.com/ind/strategy/bill_pov/200209/report.pdf.
36 See, e.g., W.R. Hambrecht + Co., OpenIPO: How It Works, http://www.whambrecht.com/ind/auctions/openipo/index.html# (last visited Jan. 2, 2007) (“Shares are allocated in an equal and impartial way by the auction process. There is no preferential allocation. . . . All individual and institutional investors pay the same price per share.”).
Dutch IPO produces a more accurate price by utilizing bids to obtain actual investor valuations efficiently. These rationales animate a belief that an auction-based IPO is the “logical offering procedure for issuers who are pursuing the twin goals of minimizing their cost of capital and obtaining a shareholder base.” In sum Dutch IPOs are believed to provide “a more transparent IPO process” and “a more efficient market for IPOs” that will “transform the IPO process” and ultimately lead to “elimination of the bookbuilding method.”

This article cautions against such belief. Part I scrutinizes criticisms of bookbuilding that revolve around the dual phenomena of underpricing and spinning. Critics regard underpricing as inefficiency generated by an agency problem; this account, however, sidesteps the more dominant account of underpricing as compensation in exchange for asymmetrical information. Critics also have asserted a link between underpricing and spinning, in which the former phenomenon feeds into the latter; this link, however, relies on limited data and largely dissolves in the face of new and proposed regulations. Additionally, both sets of criticisms fashion policy prescriptions from anecdotal and statistical evidence based on the anomalous and brief internet bubble period.

Part II evaluates the empirical case for auction-based IPOs. Three data sets are examined to determine whether this alternative method is a superior way to mitigate, much less eliminate, underpricing. The first data set is from Google’s IPO, which featured peculiarities that delimit its utility as a case study; nevertheless, Google’s first-day returns far exceed that of all other IPOs over the same time period. The second data set is from W.R. Hambrecht + Co.’s OpenIPO, the only U.S. online auction platform; the first-day returns not only fail the 10% standard offered by owner Bill Hambrecht himself, but OpenIPOs also appear to suffer from their inclusion of unsophisticated bidders and lose value dramatically over the long-run. The third data set is from international experiments with auction-based IPOs; of 23 foreign countries that have...
permitted the method, 18 effectively have abandoned it, and the existing
Israeli and French variants have yielded mediocre returns.43

Part III presents challenges auction-based IPOs pose to any
regulatory body. Prospective investors have resort to a variety of
manipulative strategies that circumvent the Dutch IPO’s primary
antifraud devices.44 Moreover, all auctions are uniquely susceptible to
fraud in the form of bidding rings, whose simplicity is matched only by
their resilience.45 These strategies and rings are both easy to execute and
yet difficult to detect, much less deter. Collectively, empirical and
theoretical analyses reveal that the claims for auction-based IPOs are
more mythical than manifest.

I. INITIAL PUBLIC OFFERINGS

Issuers go public for a variety of reasons. While IPOs predominantly
serve to raise working capital, they also can generate prestige and
publicity, and stimulate future financing opportunities.46 Whatever the
objective, issuers overwhelmingly enlist the assistance of underwriters,
who conduct meetings and road shows to gauge demand, conduct price
discovery, and “build a book” of investors.47 And the dominant metric
for IPO performance is pricing. Over the past 26 years U.S. IPOs have
been underpriced on average by 17.4%.48 During the 1999-2000 internet
bubble period, mean underpricing was a staggering 63.3%.49

Since that bubble burst commentators have advanced complex
criticisms of bookbuilding. One strand charges underwriters as agents
that underprice shares as part of a larger “pump-and-dump” scheme to
benefit themselves and managers. Another strand charges underpricing
as part of a self-perpetuating cycle that involves spinning shares to
certain investors. This Part assesses these criticisms in light of empirical
data, finance theory, and legal regulations.

A. Underpricing Underwriters

Going public serves two primary constituencies. An IPO facilitates
the ability of an issuer’s shareholders to diversify their holdings and

43 See infra Part II.B.
44 See infra Part III.A.
45 See infra Part III.B. Cf. ROUNDERS (Miramax 1998) (“Listen, here’s the thing. If
you can’t spot the sucker in the first half hour at the table, then you are the sucker.”)
(emphasis in original) (Matt Damon aka Mike McDermott).
46 But see Jay R. Ritter & Ivo Welch, A Review of IPO Activity, Pricing, and
Allocations, 57 J. Fin. 1795, 1796 (2002) (“Nonfinancial reasons, such as increased
publicity, play only a minor role for most firms” in their decision to go public.).
47 See infra notes 56-57 and accompanying text.
48 See infra notes 59-62 and accompanying text (Table 1, U.S. IPO Returns, 1980-
2005).
49 See infra notes 128-129 and accompanying text (Table 2, Internet Bubble IPO
And an IPO facilitates the ability of an issuer’s managers to raise funds for new projects. While these rationales are not mutually exclusive, managerial pursuit of new projects dominates diversification of shareholder portfolios.

And managers clearly prefer the bookbuilding method for IPOs. The vast majority of IPOs utilize underwritten financing, and overwhelmingly on a firm-commitment basis whereby underwriters fully assume the risk of distribution. Through meetings and road shows underwriters offer investors valuable information about the issuer in exchange for their superior information about private valuations and the market in general, as otherwise “investors have no incentive to reveal positive information before the stock is sold.” With this information underwriters construct a demand curve to formulate an offering price.

Correspondingly, the most robust index of IPO performance is accurate pricing of shares. Specifically, IPOs are evaluated by the spread between a share’s opening and closing prices on the first-day of trading. Table 1 summarizes IPO activity over the past 26 years:

---

50 See, e.g., DAVID P. SUTTON & M. WILLIAM BENEDETTO, INITIAL PUBLIC OFFERINGS: A STRATEGIC PLANNER FOR RAISING EQUITY CAPITAL 15 (1988) (“Added financial stability from the raising of needed capital, is by far the most important reason for going public.”).
52 Indeed, long-term shareholders may prefer reinvestment of an IPO’s proceeds over dividends, while managers conversely may prefer going public to divest themselves of some ownership in the firm. See, e.g., Kevin Rock, Why New Issues Are Underpriced, 15 J. FIN. ECON. 187, 195 (1986).
53 JAMES B. ARKEBAUER WITH RON SCHULTZ, CASHING OUT: THE ENTREPRENEUR’S GUIDE TO GOING PUBLIC 5 (1991) (citing 1985 study by John E. Young of 562 IPOs, in which “the majority of CEOs cited [these] two fundamental reasons for going public”).
54 See, e.g., Hurt, Moral Hazard, supra note 27, at 733 (“In the United States, the dominant method of distributing IPO shares is the bookbuilding method.”).
55 See, e.g., Janet Cooper Alexander, The Lawsuit Avoidance Theory of Why Initial Public Offerings Are Underpriced, 41 UCLA L. REV. 17, 68 n.190 (1993) (observing firm-commitment underwritings “make up over 95% of IPOs”).
56 Lawrence M. Benveniste & Paul A. Spindt, How Investment Bankers Determine the Offer Price and Allocation of New Issues, 24 J. FIN. ECON. 343, 344 (1989); see also IPO COMM., REPORT, supra note 11, at 20 (“Roadshows have traditionally been considered a key opportunity for large, primarily institutional, investors to gather additional information about IPO issuers, enjoy face-to-face exposure to senior management and learn management’s view of the most important aspects of the company and the offering. . . . Many large investors will not participate in IPOs unless they are provided an opportunity to meet and evaluate management during the roadshow.”);
57 See, e.g., Daily et al., supra note 3, at 274 (“The road show is designed to gauge the anticipated demand for the firm’s stock and serves as a key input in the investment banker’s final determination of the price at which the firm’s stock will initially trade.”).
58 Underpricing precisely refers to a positive difference between the closing and offering prices, while overpricing refers to the inverse. Imprecise usage of underpricing is tolerated, presumably because, “[w]hile instances of overpricing are common, studies of new issue pricing conclude that, on average, underwriters underprice new issues.” Lynn A. Stout, The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation, 87 MICH. L. REV. 613, 659 (1988).
The annual total reached its apex in 1996, when there were 687 IPOs, and reached its nadir in 2003, when there were only 68 IPOs.\textsuperscript{53}

While simple to document, underpricing remains an enigma. Empirical studies yield mixed results about what \textit{ex ante} indicia correlate reliably with underpricing.\textsuperscript{64} And commentators are divided over whether underpricing evinces that issuers have an informational advantage over prospective investors,\textsuperscript{65} or vice versa.\textsuperscript{66}

Signaling theory provides a dominant positive account of IPO underpricing.\textsuperscript{67} According to this account underpricing manifests poor or deficient information about an offered stock’s value.\textsuperscript{68} To be sure,

\begin{table}[h!]
\centering
\begin{tabular}{|c|c|c|c|}
\hline
\textbf{YEAR} & \textbf{OFFERINGS PER YEAR} & \textbf{MEAN FIRST-DAY RETURN}\textsuperscript{59} & \textbf{MEAN 3-YR. RETURN}\textsuperscript{60} \\
\hline
1980-84 & 219.2 & 7.6\% & 23.8\% \\
1985-89 & 256.8 & 6.0\% & 18.1\% \\
1990-94 & 342.2 & 11.1\% & 45.1\% \\
1995-99 & 487.0 & 28.1\% & 19.2\% \\
2000-04 & 158.0 & 33.1\% & (36.0\%)\textsuperscript{61} \\
2005 & 169.0 & 9.8\% & --- \\
\hline
\textbf{MEAN} & 287.9 & 17.5\% & 22.2\% \\
\textbf{MEDIAN}\textsuperscript{62} & 309.5 & 33.6\% & 43.2\% \\
\hline
\end{tabular}
\caption{U.S. IPO RETURNS, 1980-2005}
\end{table}

\textit{TABLE 1}

\textit{THE DUTCH AUCTION MYTH}

\textsuperscript{59} See Ritter, supra note 1, at 10 (excluding American Depository Receipt, Best Efforts, Closed-End Fund, Partnership, Real Estate Investment Trust, Regulation A, and Unit offerings as well as those with an offer price less than $5.00).

\textsuperscript{60} See id. at 19 (excluding American Depository Receipt, Bank and S&L, Closed-End Fund, Real Estate Investment Trust, and Unit offerings as well as those with an offer price less than $5.00).

\textsuperscript{61} This is the mean three-year return for 2000-02.

\textsuperscript{62} The median was calculated with absolute values.

\textsuperscript{63} Id. Mean underpricing reached its apex in 1999 at 69.6\% and its nadir in 1984 at 2.5\%. Id.; see also infra notes 128-129 and accompanying text (Table 2, Internet Bubble IPO Returns, 1998-2001).

\textsuperscript{64} See, e.g., Daily et al., supra note 3, at 272 (“[T]he extant literature reveals little consistency in reported findings when focusing on the correlates of underpricing; i.e., those \textit{ex ante} factors associated with underpricing.”).


\textsuperscript{67} Daily et al., supra note 3, at 276; see also id. at 275-76 (citing various competing positive accounts of IPO underpricing). Even proponents of competing accounts acknowledge that the “best established of these [theories of underpricing] are the asymmetric information based models.” Alexander Ljungqvist, \textit{IPO Underpricing, in HANDBOOKS IN FINANCE: EMPIRICAL CORPORATE FINANCE} 1, 2 (2004).

\textsuperscript{68} See generally Stephen Ross, \textit{The Determinants of Financial Structure: The Incentive Signaling Approach}, 8 Bell. J. Econ. 23 (1977).
THE DUTCH AUCTION MYTH

Issuers and investors engage in some decision-making with imperfect information. Issuers, however, can combat such imperfections through observable and unique signals that convey a more accurate valuation of an issuer. Within the context of IPOs these signals primarily come in the form of the issuer’s prospectus, which provides investors insights into a firm, and thus reduces risk and speculation about the IPO.

Signaling theory also suggests a normative account of underpricing, where the most controversy exists. Within the financial literature “there is little consensus regarding whether underpricing is a preferred or unwelcome outcome of the IPO process.” One interpretation of underpricing is that it manifests informational inefficiencies.

But most of the criticism has been directed at underwriters. Some commentators cite the problem that issuers “are at an informational or bargaining disadvantage relative to the underwriters who are privy to the market demand for the IPO shares,” which “often leads to the underpricing of initial public offerings.” Others contend that underpricing is symptomatic of a massive “pump-and-dump” scheme:

This IPO price curve is the expected result of a concerted effort of the investment banks and other industry insiders to extract wealth from the investing public by acquiring stock, hyping that stock, and then selling that stock.

According to this account, underwriters and managers unduly engage in underpricing to increase the probability that pre-IPO allocations will be profitable. That profit comes in the form of personal holdings as well as

---

71 See generally Craig S. Galbraith et al., Offering Prospectuses, Competitive Strategies, and the Pricing of Initial Public Offerings, 6 J. Private Equity 31, 31-32 (2003). This version of signaling theory is premised on issuers having an information advantage over prospective investors.
72 Daily et al., supra note 3, at 274.
73 See, e.g., James C. Spindler, Research Analyst Conflicts, the Market for Underwriting Business, and Credible Signaling 17 (July 2004) (“If issuers and underwriters may have positive information about themselves that they cannot disclose in the prospectus due to overbearing liability, they face an adverse-selection, or ‘lemon,’ problem in marketing the issuer’s securities to investors . . . .”), available at http://ssrn.com/abstract=564381; see also generally George A. Akerlof, The Market for “Lemons”: Quality Uncertainty and the Market Mechanism, 84 Q. J. Econ. 488 (1970).
76 See, e.g., Ian Ayres & Stephen Choi, Internalizing Outsider Trading, 101 Mich. L. Rev. 313, 334 n.65 (2002) (referencing “pump and dump” schemes under which an investor first purchases a large quantity of a company’s securities, portrays the company as favorable, and then sells the securities as the price increases”).
77 Hurt, Moral Hazard, supra note 27, at 717; see also Coffee, supra note 10, at 6 (“Such an extravagant discount cannot be justified . . . particularly when the vast majority of shares in IPOs go to a concentrated group of mutual funds and money managers.”).
reciprocal future business from prominent investors, and arguably at the expense of the issuer.

Underpricing, however, is better regarded as a form of compensation, and not inefficiency. The consequences of a “sticky,” or unsuccessful, issue can be devastating for underwriters. To be sure, they do receive a commission in exchange for assuming the actual and reputational risks of reselling shares to the public. But underpricing functions as insurance against such risks. A conservative offering price can increase the probability that stock will “pop” on the first day, which may entice investors to purchase all available shares. Further, a pop rewards recipients of preferentially allocated shares, who are often repeat investors with considerable incidental business. And a pop arguably

---

78 See, e.g., Francesca Cornelli & David Goldreich, Bookbuilding and Strategic Allocation, 56 J. Fin. 2337, 2338-39 (2001) (finding that “bidders who participate in a large number of issues receive favorable treatment,” but failing to find evidence that such investors “earn profits beyond those earned by other investors”).

79 See, e.g., Hurt, Moral Hazard, supra note 27, at 761-62 (contending that underpricing represents distorted decision-making by managers and underwriters about when to go public, on the basis that “in boom periods, more underwriters bring more issuers to market” while “[i]n cold periods, underwriters bring fewer issuers to the market”). But see, e.g., Jean Helwege & Nellie Liang, Initial Public Offerings in Hot and Cold Markets, 39 J. Fin. & Quantitative Analysis 541, 544 (2004) (“Hot and cold market IPOs do not differ in the use of discretionary accruals or by analysts’ earning growth forecasts, nor do hot market IPOs have lower institutional ownership after the IPO.”); Daniel L. McConaughy et al., Agency Costs, Market Discipline and Market Timing: Evidence from Post-IPO Operating Performance, 20 Entrepreneurship: Theory and Practice 43, 43 (1996) (“Entrepreneurs who bring their firms into the public securities markets maintain the pre-IPO performance of their firms. This suggests that agency costs do not increase significantly and that the poor post-IPO stock market performance is due more to over-optimistic investors extrapolating current growth into the future.”) (emphasis added). An additional problem with this “pump-and-dump” account is that the internet bubble period did not experience any appreciable increase in the rate at which issuers went public. See infra notes 128-129 and accompanying text (Table 2, Internet Bubble IPO Returns, 1998-2001).

80 See, e.g., LOUIS LOSS & JOEL SELIGMAN, SECURITIES REGULATION 80 (3d ed. 1998) (“The purpose of the dealer’s participation in the underwriting is to ensure a rapid sale of the offering. If a rapid sale were not to occur, the issue might become ‘sticky,’ depressing the sales price and reducing (or eliminating) the underwriters’ profit.”).


82 Further, firm-commitment IPOs typically are priced four business days before an issue’s debut, during which there is a risk of decline. See, e.g., Deanna L. Kirkpatrick, The Underwriting Agreement, in HOW TO PREPARE AN INITIAL PUBLIC OFFERING 277, 288 (2004).

83 See, e.g., Griffith, supra note 14, at 605-06 n.71 (citing 2002 poll in which “over 70% of respondents agreed or strongly agreed with the statement that ‘high first day returns are necessary to gain interest in the IPO.’”) (quoting Patricia A. Ryan & Irv DeGraw, A Brief Comparison of the Oct 2000-June 2002 IPO CFO Results to the 1996-1998 IPO tbl. 7 (working paper)).

84 See, e.g., Francesca Cornelli et al., Pre-IPO Markets 2 (2003) (“In the literature, the exclusion of retail investors from bookbuilding has typically been justified by arguing that retail investors are uniformed and it is optimal to restrict the participation in
suggests a limited basis, if any, for damages, thus dissuading prospective plaintiffs from bringing claims under the Securities Act.

Moreover, underpricing is governed by powerful market norms. The persistence of underpricing over time has created an entrenched expectation within investors to witness substantial first-day pops from quality IPOs:

If, on average, an investment banker does not underprice its offerings enough, the average initial return will be too low, and uninformed investors will cease doing business with this underwriter. On the other hand, if, on average, an investment banker underprices its offering too much, so that the average initial return is too high, potential issuers will cease using this underwriter. An underwriter’s objective thus is to set an offering price optimally beneath, and not equal to, its projected closing price.

This objective is difficult to accomplish because of an underwriter’s competing constituencies. On the one hand issuers prefer underwriters with an established track record of leaving only a limited amount of money on the table. On the other hand aftermarket investors tend to view underpricing as a proxy of an underwriter’s quality, even though they tend to receive limited personal benefits from first-day pops.

---

86 See generally Alexander, supra note 55, at 17.
88 Investors also respond to the actual offering price. See, e.g., Daily et al., supra note 3, at 280 (“[A] very modest offer price will signal little demand, little value, or both.”). But cf. infra notes 103, 196, and accompanying text.
89 See, e.g., Richard B. Carter et al., Underwriter Reputation, Initial Returns, and the Long-Run Performance of IPO Stocks, 53 J. Fin. 285 (1998) (finding a strong inverse correlation between an underwriter’s reputation and underpricing); Dennis E. Logue, Premia on Unseasoned Equity Issues, 1963-69, 25 J. Econ. & Bus. 133, 135 (1973) (examining 83 issues and finding that those “underwritten by prestigious investment bankers was 20.8 percent, whereas the average performance of issues underwritten by non-prestigious investment bankers was 52.1 percent”). Logue also finds that “prestigious investment bankers handle significantly larger offerings than do non-prestigious investment bankers.” Id.
90 See, e.g., Jay R. Ritter, The “Hot Issue” Market of 1980, 47 J. Bus. 215, 220 (1984) (“[I]ndividuals face an adverse selection problem when submitting a purchase order. If the issue is overpriced . . . , only uninformed investors will submit purchase orders.”). See also Daily et al., supra note 3, at 277 (“The vast majority of IPO shares are not initially sold on the open market; rather, they are sold to key clients of the underwriters . . . [who] want to reduce underpricing”).
91 See, e.g., Daily et al., supra note 3, at 275 (“Uninformed investors realize that, on average, they will earn below-average returns.”). This can be explained partially by the fact that underwriters justifiably favor “bidders who reveal information through limit prices” and those “who participate in a large number of issues,” which “is consistent with the argument that such investors are being compensated for the insurance they provide.” Cornelli & Goldreich, supra note 78, at 2338-39.
Underwriters thus must negotiate a delicate balancing act. To be sure, there is anecdotal evidence of underwriters and managers engaging in “pump-and-dump” schemes. But this hardly proves a systemic defect in bookbuilding, and certainly fails to appreciate its broader and more established justifications.

B. Spinning Bubbles

Another strand of attack against bookbuilding concerns spinning. This practice of preferentially allocating pre-market IPO shares to investors is routine. Underwriters spin an estimated 79% of IPO shares to executives, institutional investors, politicians, as well as their family and friends. The bulk of spun shares end up in the hands of institutional investors, who receive anywhere from 70% to 85% of an offering’s total allocation.

Spun shares are not merely a mark of privilege, but also a potential source of profit. Recipients may retain spun shares for aftermarket gain or sell them at a premium to third parties, otherwise known as flipping. Spinning also is one among many widely-sanctioned explanations for underpricing. Specifically, underwriters offer shares at a lower price to influential and prominent investors as compensation for their assumption of early IPO risk.

---

92 See, e.g., Daily et al., supra note 3, at 277 (“Underwriters are dual agents with two key constituents in the IPO process. The first constituent is the firm whose securities the underwriters represent. The second is the client base to whom the underwriters market the IPO securities.”).

93 See supra notes 76, 79, and accompanying text.

94 See, e.g., Hurt, What Google Can’t Tell Us, supra note 27, at 404 (“In almost all IPOs conducted in the United States, the vast majority, almost 80%, of original IPO shares are pre-allocated by the underwriters of the offering.”) (citation omitted).

95 See, e.g., Letter from Jane C. Sherburne, Deputy General Counsel of Citigroup, Inc., to Michael G. Oxley, Chairman of the House Committee on Finance Services, and John J. LaFalce, Ranking Member of the House Committee on Financial Services, http://financialservices.house.gov/media/pdf/citidocs_001.pdf (Aug. 26, 2002); Hillary A. Sale, Disappearing Without a Trace: Sections 11 and 12(a)(2) of the 1933 Securities Act, 75 WASH. L. REV. 429, 441 (2000) (“[O]n average, small investors receive less than one quarter of the total shares in an IPO. In the typical IPO, the percentage of offered shares allocated to institutional investors generally ranges from 70% to 85% of the total shares.”) (citation omitted).

96 See, e.g., Griffith, supra note 14, at 587 (“[S]pinning allocations rarely, if ever, result in trading losses.”). Griffith contends that “underwriters only spin shares of hot offerings—that is, those for which there is significant aftermarket demand.” Id. at 587 n.12.

97 See, e.g., Royce de R. Barondes, NASD Regulation of IPO Conflicts of Interest--Does Gatekeeping Work?, 79 TUL. L. REV. 859, 884 (2005) (“Some investors who purchase stock in an IPO quickly resell the stock, known as ‘flipping,’ to realize the short-term gains.”). See also id. at 885-86 (noting various types of anti-flipping mechanisms).

98 See supra Part I.A.

99 See, e.g., Griffith, supra note 14, at 594, 597 (“Spinning improves the underwriter’s welfare by generating goodwill on the part of the recipient of the spun shares . . . . Underwriters may also seek to use spinning allocations to win the favor of politicians and government officials.”).
probability that the issue will be subscribed fully and diversity of ownership that guards against concentrated holdings by a few institutional investors.\textsuperscript{100}

Spinning, however, is believed to be linked to underpricing. According to one theory, “[u]nderpricing enables spinning by providing underwriters with a ready supply of hot IPO shares. But underpricing is also an end of spinning when hot allocations are used to induce issuer-managers to underprice their own offerings.”\textsuperscript{101} Underwriters are said to discount the price of shares based on the corresponding commission foregone versus the short- or long-term returns.\textsuperscript{102} When these returns, which can come in many forms such as insurance against a sticky issue or protection from Securities Act liability,\textsuperscript{103} are sufficient, underwriters will have an incentive to underprice shares. Akin to a casino’s “comp” system, these shares then can be flipped in exchange for goodwill.\textsuperscript{104}

In this way underpricing is believed to be a necessary predicate for spinning. Unlike other pre-IPO allocation practices, spinning is conceived within this account as a practice by which underwriters direct “allocations to particular individuals, usually those in positions of power and influence, rather leaving the syndicate’s brokers with the discretion to dole out individual allocations to just anyone.”\textsuperscript{105} This practice is not about playing favorites, but generating profits. Underwriters spin IPO shares allegedly because they expect issuer-managers to agree to underprice shares.\textsuperscript{106} Receiving these shares induces managers of the

\textsuperscript{100} See supra notes 83-86 and accompanying text.

\textsuperscript{101} Griffith, supra note 14, at 589-90; see also Cumming & McIntosh, supra note 8, at 890 (“From a regulatory point of view, the message seems clear: extreme underpricing of new issues is likely to be associated with illicit activities such as ladder[ing], false analyst coverage, spinning, and so on.”).

\textsuperscript{102} See id. at 599 (“Underpricing will be worthwhile to underwriters on the margin provided that the value of the insurance and goodwill generated through underpricing exceeds the commission losses . . . .”; supra notes 83-86 and accompanying text.

\textsuperscript{103} See supra note 86 and accompanying text. Griffith contends that “underwriters probably only consider underpricing as insurance at [marginally] higher price levels where the increased risk of a sticky issue marginally outweighs the expected return from an incremental increase in offering price.” Griffith, supra note 14, at 593.

\textsuperscript{104} Griffith, supra note 14, at 594-99.

\textsuperscript{105} Id. at 587 (emphasis in original); see also Sale, supra note 94, at 441 (“Small investors ‘can rarely get in on . . . hot’ initial public offerings (IPOs) because IPOs are largely ‘private club[s] that the average investor [i]sn’t invited to join.’”) (quoting Aaron Lucchetti & Terzeh Ewing, IPO Fund Paradox: Sector Is Hot, Investors Are Cool, WALL ST. J., Sept. 3, 1999, at C1; Terzeh Ewing, The Road Now Taken: Exclusive Shows Touting New Issues Arrive on the Web, WALL ST. J., Sept. 22, 1999, at C1).

\textsuperscript{106} Griffith, supra note 14, at 623-24. In receiving spun shares managerial shareholders arguably have breached their fiduciary duties. See, e.g., William H. Donaldson, Testimony Concerning Global Research Analyst Settlement, Statement Before the Senate Committee on Banking, Housing, and Urban Affairs, \url{http://www.sec.gov/news/testimony/ts050703whd.htm} (May 7, 2003) (noting that spinning “raises serious questions about whether the corporate insiders who take hot IPO shares in exchange for their firms’ investment banking business are breaching their fiduciary duties to their shareholders”). See also Anita Indira Anand, Is the Dutch Auction IPO a Good Idea?, 11 STAN. J.L. BUS. & FIN. 233, 255 (2006) (noting that “corporate law currently has rules in place to deal with certain types of unfairness, such as spinning,” such as fiduciary duties and the corporate opportunity doctrine).
issuor going public to permit underpriced shares, which can increase the likelihood of a profitable flip. Receiving these shares also induces the managers of other issuers going public to retain these same spinning underwriters and permit underpriced shares. Both scenarios thus involve a “complex wealth transfer,” in which managers employ underwriters to pocket money deliberately left on the issuer’s table. Simply formulated, spinning taps into the incentives for underpricing, which guarantees a supply of spinnable shares.

Recent and proposed regulations, however, sever part of this link. NASD Rule 2790 prohibits certain “restricted persons” from receiving IPO allocations. Among such persons are broker-dealers as well as, their affiliates and relatives, finders and fiduciaries, and portfolio managers. And proposed NASD Rule 2712 prohibits broker-dealers and their associates from allocating shares from an IPO on a quid pro quo basis for past or future investment banking business, a bar that extends to directors or executives of a recent client of the underwriting syndicate. These rules eliminate most forms of spinning, and thus disrupt the possibility of any real “complex wealth transfer.” This is because spinning no longer represents a quasi-legal means for underwriters and managers to divert offering proceeds to themselves. To be sure, some diversion still may occur; but its illegality severely

---

107 See supra note 97 and accompanying text.
108 Griffith, supra note 14, at 623-24 (“By spinning underpriced shares of other issuers to their counterparts across the negotiating table, underwriters may hope to induce them to accept underpricing in their own offering.”).
109 Id. at 624.
110 For issuers, however, the rationality of underpricing is less clear. As Griffith notes, “[i]ssuers lose $0.93 per dollar of underpricing. Underpricing is thus much more expensive to issuers than it is to underwriters. So why do they do it?” Griffith, supra note 14, at 600 (calculating issuers’ losses based on underwriters receiving their standard 7% commission rate); see also supra note 81.
111 Id. at 594 (“Underwriters assure themselves of a supply of shares for spinning by underpricing IPOs.”).
112 NASD, MANUAL (CCH), R. 2790(a) (Apr. 2005) (“Restrictions on the Purchase and Sale of Initial Equity Public Offerings”) [hereinafter NASD, R. 2790]. Rule 2790 expands the restrictions first established by the Free-Riding and Withholding Interpretation, which applied only to hot issues and thus earned the name of the Hot Issue Rule. See NASD, MANUAL (CCH), IM-2110-1 (Apr. 2003).
113 NASD, R. 2790(i)(10), supra note 112.
114 See Notice of Filing of Proposed Rules Changes by the New York Stock Exchange, Inc. and the National Association of Securities Dealers, Inc. Relating to the Prohibition of Certain Abuses in the Allocation and Distribution of Shares in Initial Public Offerings (“IPOs”), Sec. Rel. No. 34-50896, 69 Fed. Reg. 77804, 77805 (Dec. 20, 2004) (“IPO Allocations and Distributions”) [hereinafter NASD, R. 2712]. But see Hurt, What Google Can’t Tell Us, supra note 27, at 407 (“Unfortunately, proposed rule 2712 has been open for comment for almost four years, indicating that the Rule is unlikely to be accepted.”).
115 Neither rule prohibits directed-share plans or allocations to institutional investors, and yet, interestingly, both practices are excluded from Griffith’s conception of spinning. See supra note 14 and accompanying text. Directed share plans are not part of the conception of spinning used here, as such plans are conducted by the issuer and constitute a small percentage of allocations. See id.
dampens the extent to which underwriters and managers will underprice to spin.

Moreover, the interconnection between spinning and underpricing has more conjectural appeal than empirical support. To redress an admitted “poverty of direct comparative data,”\(^{116}\) Griffith presents findings from three empirical studies. The first study, by Griffith himself, examines eleven firms from 1999 to 2000 with inside managers who allegedly spun shares, and finds the mean underpricing for these IPOs exceeded that for their counterparts.\(^{117}\) The second study, by Tim Loughran and Jay Ritter, observes: “As IPO underpricing increased in the 1990s . . . the ability to use hot IPOs to reward decision-makers resulted in the decision-makers seeking out underwriters with reputations for leaving money on the table, rather than avoiding these underwriters.”\(^{118}\) These findings comport with the final study, by William Ljungqvist and William Wilhelm, of IPOs from 1996 to 2000, that confirms “underpricing is significantly lower when insider ownership stakes are larger and less fragmented and when insiders sell more shares at the offer price.”\(^{119}\) From this Griffith infers that “[d]ecreased insider ownership suggests decreased manager incentives to monitor the pricing process.”\(^{120}\)

A closer examination of these studies, however, reveals inferential gaps. If spinning and underpricing are linked, there should be a miniscule level of insider ownership within this data set. Ljungqvist and Wilhelm in fact conclude that “insider percentage holdings declined over the sample period [1996-2000] . . . .”\(^{121}\) Loughran and Ritter, however, find that, from 1999 to 2000, “CEO dollar ownership (the market value of the CEO’s holdings) was substantially higher, resulting in increased incentives to avoid underpricing.”\(^{122}\)

The difference between these two findings is subtle, but significant. Unlike Ljungqvist and Wilhelm, who measure insider ownership as a percentage of total shares offered, Loughran and Ritter focus on the total monetary amount of what insiders own.\(^{123}\) The latter measure would seem to evince stronger incentives for insiders to underprice, as those who own a significant portion of the offering, but individually have small

\(^{116}\) Griffith, supra note 14, at 627.

\(^{117}\) See id. at 626. Griffith notes certain methodological caveats to this data set, specifically, that the number of IPOs with insiders is likely underinclusive and that the underpricing levels for these IPOs are also included within the average for all IPOs. As a result, he cautions against using “these data to compare the underpricing margins of firms engaging in underpricing to those that do not.” Id. at 627. Nevertheless he maintains that “these weaknesses of the data set make the argument for a link between spinning and underpricing stronger, not weaker.” Id.

\(^{118}\) Id. at 629 n.155 (quoting Tim Loughran & Jay Ritter, Why Has IPO Underpricing Changed over Time?, 33 FIN. MGMT. 5, 30 (2004)).


\(^{120}\) Griffith, supra note 14, at 629.

\(^{121}\) Ljungqvist & Wilhelm, supra note 119, at 2.

\(^{122}\) Loughran & Ritter, supra note 118, at 6 (emphasis in original).

\(^{123}\) Id. at 21
investments or expected spinning profits, may not be as motivated to risk deliberate underpricing. Ultimately, Loughran and Ritter find “little support” for the Ljungqvist and Wilhelm hypothesis. And, at any rate, Griffith utilizes neither metric in his data set, which simply establishes the margin of underpricing within firms that allegedly spun shares to insiders.

Further, all of these empirical studies have limited extrapolative value. Griffith’s arguments are predicated upon underpricing and spinning during the internet bubble, a two-year period. From 1999 to 2000 underpricing occurred on an unprecedented scale:

<table>
<thead>
<tr>
<th>YEAR</th>
<th>OFFERINGS</th>
<th>MEAN FIRST-DAY RETURN</th>
<th>MEAN 3-YR. RETURN</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>317</td>
<td>20.1%</td>
<td>27.1%</td>
</tr>
<tr>
<td>1999</td>
<td>487</td>
<td>69.6%</td>
<td>(45.2%)</td>
</tr>
<tr>
<td>2000</td>
<td>385</td>
<td>55.4%</td>
<td>(59.6%)</td>
</tr>
<tr>
<td>2001</td>
<td>81</td>
<td>13.7%</td>
<td>8.9%</td>
</tr>
</tbody>
</table>

The 63.3% mean first-day bubble return is over three times the mean for the next highest year (1995), over four times the mean for the previous eight years (1990-98), and over five times the mean for the subsequent four years (2001-05). By reference, the mean first-day return from 1990 to 1998 is 14.6%, and 11.3% from 2001 to the present. Similarly, internet bubble issuers left $62.4 billion ($32.1 billion annual mean) on the table, whereas issuers left only $28.1 billion from 1990 to 1998 ($3.1 billion annual mean), and a mere $11.6 billion from 2001 to 2005 ($2.3 billion annual mean).

---

124 Id. at 19 (“It is not obvious . . . that CEO percentage ownership is as important as the market value of these shares if we want to measure the managerial benefits of a higher offer price.”).
125 Id. at 6.
126 See Griffith, supra note 14, at 626-27.
127 See supra notes 117-120 and accompanying text.
128 Offerings, Mean First-Day and Three-Year Return Data from Ritter, supra note 1, at 10 & 19.
129 But see, e.g., Hurt, Moral Hazard, supra note 27, at 715 (citing a study that found “the average stock [in 1999] was underpriced by 65 percent” and yet another study that found “the average first-day share price increase, or ‘pop’ in 1999 was . . . 77 percent”) (citations omitted).
130 See supra notes 59-62 and accompanying text (Table 1, U.S. IPO Returns, 1980-2005).
131 Ritter, supra note 1, at 10; see also supra notes 59-62 and accompanying text (Table 1, U.S. IPO Returns, 1980-2005).
132 Ritter, supra note 1, at 2. The market for IPOs precipitously dropped from 2001 to 2003. See supra notes 128-129 and accompanying text (Table 2, Internet Bubble IPO Returns, 1998-2001). Perhaps a better measure is from 2004 to 2005, during which
A myriad of explanations for the internet bubble exist, but the relevant point is that a significant number of IPOs conducted during this two-year period involved highly unusual dynamics. Almost half of the internet bubble IPOs in the Loughran and Ritter study involved high-tech firms, which went public faster than their 1980s and early 1990s predecessors, as well as current firms. And prestigious underwriters exhibited an uncharacteristic willingness to support internet bubble offerings with their dramatically lower median sales; this comports with evidence that the quality of IPO entrants declined during the bubble period. The combined effect is that “prestigious underwriters relaxed their underwriting standards and took public an increasing number of very young and unprofitable companies” on a level that we had never seen before.

The internet bubble’s peculiar composition cautions against drawing broad conclusions and prescriptions about spinning and underpricing. Ample evidence exists that spinning depends upon underpricing. But the cycle falls apart when one attempts to examine spinning in isolation. As Loughran and Ritter ask: “If spinning is an important reason for underpricing in the bubble period, why wasn’t it important a decade earlier?” According to them, “underpricing fed on itself. . . . underpricing creates incentives for even more underpricing. What constrains underpricing from increasing perpetually without limit is that raising money is still a goal for an issuer.” If this is correct, underpricing can be constrained by the combined effect of new regulatory prohibitions on spinning and incentives for managers to generate sufficient equity. At the very least, the presented data does not clearly establish the relationship between underpricing and spinning. And the multiplicity of variables within the bubble period delimits its ability to establish any link between spinning and underpricing.

Issuers left an aggregate $3.27 billion on the table. Ritter, supra note 1, at 2. Regardless, no recent time has witnessed IPO activity and underpricing on a level seen during the internet bubble period.

134 See, e.g., Loughran & Ritter, supra note 118, at 17. Within the Ljungqvist and Wilhelm study internet firms accounted for 55% of the IPOs in 1999, and 36% of the IPOs in 2000. Ljungqvist & Wilhelm, supra note 119, at 5.
135 The median age of firms going public decreased from 7.5 years to 5 years during the internet bubble and thereafter increased to 12 years. Loughran & Ritter, supra note 118, at 18-20.
136 Id. at 22-23.
137 See, e.g., Beverly B. Marshall et al., Early Internet IPOs Versus Subsequent Entrants, 28 J. ECON. & FIN. 104 (2004). Moreover, internet bubble IPOs left more money at the table and have lower three-year returns than any other time during the past 26 years. See Ritter, supra note 1, at 2, 19.
138 Loughran & Ritter, supra note 118, at 22.
139 Id. at 12. Indeed, mean underpricing during the 1990s were the same as those in the 1960s, or around 21%. See, e.g., Ljungqvist, supra note 67, at 1.
140 Loughran & Ritter, supra note 118, at 12.
II. AUCTION-BASED IPOS

This Part evaluates the affirmative case for auction-based IPOs. Proponents contend that going public via an auction is more efficient, equitable, and egalitarian than via bookbuilding. Examining three prominent data sets for auction-based IPOs demonstrates otherwise. The first set is from Google’s IPO, the largest such auction in the U.S. to date; \(^\text{141}\) although, by most accounts, that Dutch IPO failed, its utility is limited by various peculiarities. The second set is from Hambrecht’s OpenIPO, the sole domestic auction-based platform; while generating slightly superior first-day returns than all IPOs during the relevant time period, OpenIPOs lose their value appreciably over the long-run and appear to suffer from their inclusion of unsophisticated bids. \(^\text{142}\) The final set is from foreign countries that have experimented with auction-based IPOs; not only have the vast majority of these countries effectively abandoned the method, but the remaining countries have experienced mediocre results.

A. Domestic Auction-Based IPOs

The most visible Dutch IPO to date is by Google. On April 29, 2004 Google announced that its $2.72 billion IPO would be conducted as an online auction. \(^\text{143}\) The announcement immediately captured the public’s imagination. A financial columnist from The New Yorker described the auction as “analogous to the new-model I.P.O.: forget the experts; go with the crowd. You might say that Google could Google its own stock price,” \(^\text{144}\) while a commentator suggested that this method “may push out the old model and become the industry standard.” \(^\text{145}\) The CEO of another company that had gone public via an auction speculated that Google’s IPO “could be the thing that breaks a sleazy Wall Street system.” \(^\text{146}\) And reports predicted that “[t]his type of auction should cut


\(^{142}\) See, e.g., Hurt, What Google Can’t Tell Us, supra note 27, at 412 (“[O]f the firms that developed online auction systems during the 1999-2000 Boom, only W.R. Hambrecht + Co. currently maintains an online IPO platform.”).

\(^{143}\) See Google, Form S-1, supra note 22, at 2 (“The price to the public and allocation of shares will be determined by an auction process.”).


THE DUTCH AUCTION MYTH

down on the huge run-up in share price experienced during the first days of trading experienced by other tech IPOs during the 1990s.”

In many ways, however, Google’s IPO was anything but unorthodox. The company enlisted a syndicate of 28 blue-chip underwriters, led by two highly established investment banks, Morgan Stanley & Co. Inc. and Credit Suisse First Boston LLC, neither of which had any experience with online Dutch IPOs. Google also quietly allocated to these underwriters approximately 15% of the IPO shares outside of the auction process. Similarly well-positioned was a cadre of prominent individuals and institutions who had acquired ownership stakes in Google well before it even planned to go public; these shareholders stood to profit handsomely from the IPO, regardless of whether the firm used an auction or bookbuilding. And while Brin and Page did indicate that they were “encouraging current shareholders to consider selling some of their shares as part of the offering,” their efforts evidently focused more on retail and small investors, prompting a charge that “some investors selling shares in the offering were more equal than others.”

Perhaps the greatest misperception about Google’s IPO is that it was a pure Dutch auction. Well before the IPO was announced, there was rampant speculation that bids would determine the final offering price.

institutional banking,’ says Alison May, CEO of RedEnvelope [which had used a Dutch IPO], ‘They’re fighting for survival.’”)


1.48 See Google, Amended Form S-1, supra note 21, at 35.

1.49 See Hurt, What Google Can’t Tell Us, supra note 27, at 416 (noting that Morgan Stanley and CSFB are “not known for IPO innovation and had never offered an online IPO auction before”).


Google’s S-1 suggested the same, sandwiching between various caveats that: “We intend to use the auction clearing price to determine the initial public offering price and, therefore, to set an initial public offering price that is equal to the clearing price.” Google, however, also retained the option of setting the final offering price “in response to investor demand”; bidders thus had no assurance that the clearing price would be the final offering price.

Indeed, despite all its auction-related fanfare, Google ultimately did exercise its pricing discretion. Just before its market debut, the company lowered the clearing price range from $108-135 to $85-95, and then set the final offering price at $85. By most accounts this was prompted by investor uncertainty stemming from a number of snafus, ranging from SEC concern about employee share distributions to an interview with Brin and Page that arguably breached the mandatory “quiet” period. That uncertainty persisted into the days leading up to the IPO, leaving the offering undersubscribed and reportedly prompting Google’s CEO, Eric Schmidt, to pronounce that “the auction had failed.” Accordingly, Google’s eleventh-hour price changes were designed to ensure sufficient demand and generate an aftermarket pop, a charge ordinarily leveled against bookbuilding underwriters.

The move worked. During the first-day of public trading Google’s shares changed hands 22 million times and appreciated in value 18.1%, hardly frustrating those seeking to profit from an initial pop. These

---

155 See Google, Amended S-1, supra note 21, at 38. This is not to suggest that Google mislead prospective investors, as the S-1 is sprinkled with well-placed statements about the company’s “discretion to set the initial public offering price below the auction clearing price.”

156 See id. at 34.

157 See id. at 31 (“Our goal of achieving a relatively stable market price may result in Google determining with our underwriters to set the initial public offering price below the auction clearing price.”).

158 See id. at 34, 40.

159 Google enforced this price range by reserving the right to refuse substantially higher bids that seemed part of a manipulative strategy. See id. at 34, 40.


161 Delaney, supra note 153, at A11.

162 See, e.g., Petruno, supra note 154, at C1 (quoting Jay Ritter’s opinion that, “by lowering its expected price range to US$85-95, Google probably triggered a last-minute rush by institutional bidders to the US$85 level.”).

163 See supra Part I.A.

164 Data from http://moneycentral.msn.com/investor/charts/chartdl.asp?Symbol=goog&DateRangeForm=1&PT=5&CP=1&C5=8&C6=2004&C7=7&C8=2005&C9=0&ComparisonsForm=1&C=E=0&CompSyms=&DisplayForm=1&D4=1&D5=0&D7=&D6=&D3=0&ShowTablBt=Show+Table (last visited Jan. 2, 2007).
returns, which exceeded the 11.1% mean for all IPOs that year and the 17.5% mean for the past 26 years,\textsuperscript{165} combined with the approximately $300 million left on the table hardly proved the auction was a paragon of efficiency. Rather, by most accounts, Google’s IPO largely failed to fulfill the promises that had made it the darling of the investing public.\textsuperscript{166}

Ironically, auction proponents have been the quickest to point out the impure nature of Google’s Dutch IPO. For instance, one commentator has noted that, “[a]lthough the Dutch auction gave Google the ability to set a market clearing price for its shares, the modified Dutch auction described in the prospectus did not require Google to do so.”\textsuperscript{167} Similarly, another commentator has offered the distinction that “[i]n a true Dutch auction, the clearing price is also the offering price. In the Google offering, the issuers . . . retained the right to set the offering price below the auction clearing price,”\textsuperscript{168} and that “Google’s IPO was unique in that the issuer combined the auction platform with the support of traditional investment banks.”\textsuperscript{169}

This type of combined platform, however, is hardly unique. One of the investment advisors for Google’s IPO was W.R. Hambrecht + Co. (Hambrecht), which has offered a Dutch auction platform known as OpenIPO since 1999.\textsuperscript{170} Prospective investors submit bids one to two weeks prior to the offering’s effective date, and Hambrecht proceeds to calculate a clearing price.\textsuperscript{171} As with Google, OpenIPO issuers reserve the discretion to set a final offering price different than the clearing

\textsuperscript{165} See infra notes 59-62 and accompanying text (Table 1, U.S. IPO Returns, 1980-2005). But cf. Hurt, What Google Can’t Tell Us, supra note 27, at 438 (“In addition, if the [Google] share price was underpriced, the underpricing was negligible compared to the expected underpricing in a traditional bookbuilding IPO.”).

\textsuperscript{166} See, e.g., Andrew Wahl, ‘To Google’ Has New Meaning, 77 CAN. BUS. 21, 21 (2004) (“Rather than being a catalyst for other dot-com IPOs and the tech market in general, though, Google over-promised, underperformed, and taught everyone, including themselves, some good lessons.”). Not everyone, however, believes Google’s IPO was a failure. Bill Hambrecht, established advocate of the Dutch IPO, opined: “‘I think it worked,’ he said. ‘Think about Google’s objectives. It wanted its 100 million user base to have access to its IPO and it did that. It wanted to get rational price discovery, and it did that too.’” Joseph Nocera, Two Cheers for the Google IPO, 150 FORTUNE 42, 42 (Sept. 6, 2004) (quoting William R. Hambrecht); cf. Fleischer, supra note 28, at 1600 (“Despite [ ] apparent flaws, the Google IPO should be considered a success. The IPO . . . was a branding moment. . . . From a corporate-finance perspective, the deal was at best mediocre. From a marketing perspective, it was simply brilliant.”).

\textsuperscript{167} Hodrick, supra note 26, at 1.

\textsuperscript{168} Hurt, What Google Can’t Tell, supra note 27, at 423.

\textsuperscript{169} Hurt, Moral Hazard, supra note 27, at 31; see also Hurt, What Google Can’t Tell, supra note 27, at 433 (noting Google’s IPO also was “one of the largest in U.S. history”).


price.\textsuperscript{172} When the offering is over-subscribed, Hambrecht allocates
shares on a pro-rata basis.\textsuperscript{173}

The OpenIPO touts four primary benefits for investors. First, institutional and retail investors enjoy equal access to participating in an IPO.\textsuperscript{174} Second, these investors are permitted to submit multiple, multi-tiered bids that indicate variable interest levels in different share prices.\textsuperscript{175} Third, all investors receive the same price.\textsuperscript{176} And, finally, shares are allocated on an equal and impartial basis.\textsuperscript{177}

Since 1999 Hambrecht has completed 17 OpenIPOs.\textsuperscript{178} On average Hambrecht has conducted approximately two OpenIPOs per a year. As a reference point, from 1999 to 2005, OpenIPOs accounted for 1.07\% of all IPOs conducted in the United States,\textsuperscript{179} and 0.31\% of the total gross proceeds raised by all domestic IPOs.\textsuperscript{180} Table 3 summarizes certain OpenIPO data:

\begin{table}
\begin{tabular}{|c|c|}
\hline
\textbf{Year} & \textbf{Number of OpenIPOs} \\
\hline
1999 & 9 \\
2000 & 10 \\
2001 & 11 \\
2002 & 12 \\
2003 & 13 \\
2004 & 14 \\
2005 & 15 \\
\hline
\end{tabular}
\end{table}


\textsuperscript{175} Id.

\textsuperscript{176} Id.

\textsuperscript{177} Id.

\textsuperscript{178} The data presented here, \textit{infra} notes 181-182, span 1999 to 2006; Hambrecht has conducted OpenIPOs in 2007, but they are omitted here to preserve a set of complete calendar years. Hambrecht also was retained for another OpenIPO by an online bookseller, Alibris, but that was aborted. \textit{See} Alan J. Berkeley \textit{et al.}, \textit{Some Background and Simple FAQs About Dutch Auctions and the Google IPO}, SK003 ALI-ABA 239, 243 (2004) ("There was apparently little response, and Alibris announced it was withdrawing the offering proposal. One has to wonder if the Alibris offering could have proceeded and succeeded if there was a traditional active marketing effort through well compensated investment bankers . . . .").

\textsuperscript{179} Ritter, \textit{supra} note 1, at 11.

\textsuperscript{180} Id. at 10; see also Loughran & Ritter, \textit{supra} note 118, at 8 (noting that “[b]ookbuilding [wa]s the mechanism used to price and allocate IPOs for 99.9\%” from 1999 to 2000).
TABLE 3
OPENIPO DATA, 1999-2006

<table>
<thead>
<tr>
<th>OPENIPO DATE</th>
<th>FIRM</th>
<th>FIRM AGE</th>
<th>OPENIPO PRICE</th>
<th>OPENIPO AMOUNT</th>
<th>GROSS PROCEEDS</th>
<th>PRO RATA</th>
<th>1ST-DAY RETURN</th>
<th>ABSOLUTE 1ST-DAY</th>
<th>3-YEAR RETURN</th>
<th>ABSOLUTE 3-YEAR</th>
</tr>
</thead>
<tbody>
<tr>
<td>04/99</td>
<td>Ravenswood</td>
<td>23.0</td>
<td>$10.50</td>
<td>$11.6 M</td>
<td>$10.50 M</td>
<td>89%</td>
<td>3.62%</td>
<td>3.62%</td>
<td>(2.37%)</td>
<td>2.37%</td>
</tr>
<tr>
<td>06/99</td>
<td>Salon.com</td>
<td>4.0</td>
<td>$10.50</td>
<td>$27.3 M</td>
<td>$26.30 M</td>
<td>84%</td>
<td>(5.00%)</td>
<td>5.00%</td>
<td>(99.05%)</td>
<td>99.05%</td>
</tr>
<tr>
<td>12/99</td>
<td>Andover.net</td>
<td>4.0</td>
<td>$18.00</td>
<td>$82.8 M</td>
<td>$72.00 M</td>
<td>97%</td>
<td>252.11%</td>
<td>252.11%</td>
<td>4.00%</td>
<td>4.00%</td>
</tr>
<tr>
<td>05/00</td>
<td>Nogatech</td>
<td>7.0</td>
<td>$12.00</td>
<td>$42.0 M</td>
<td>$42.00 M</td>
<td>---</td>
<td>(21.58%)</td>
<td>21.58%</td>
<td>(3.33%)</td>
<td>3.33%</td>
</tr>
<tr>
<td>01/01</td>
<td>Peet’s Coffee &amp; Tea</td>
<td>30.0</td>
<td>$8.00</td>
<td>$26.4 M</td>
<td>$26.40 M</td>
<td>72%</td>
<td>17.25%</td>
<td>17.25%</td>
<td>113.00%</td>
<td>113.00%</td>
</tr>
<tr>
<td>05/01</td>
<td>Biazz</td>
<td>6.0</td>
<td>$8.00</td>
<td>$16.0 M</td>
<td>$16.00 M</td>
<td>70%</td>
<td>0.38%</td>
<td>0.38%</td>
<td>(98.25%)</td>
<td>98.25%</td>
</tr>
<tr>
<td>05/02</td>
<td>Overstock.com</td>
<td>5.0</td>
<td>$13.00</td>
<td>$39.0 M</td>
<td>$39.00 M</td>
<td>60%</td>
<td>0.23%</td>
<td>0.23%</td>
<td>199.62%</td>
<td>199.62%</td>
</tr>
<tr>
<td>09/03</td>
<td>Red Envelope</td>
<td>6.0</td>
<td>$14.00</td>
<td>$30.8 M</td>
<td>$30.80 M</td>
<td>56%</td>
<td>3.93%</td>
<td>3.93%</td>
<td>(39.64%)</td>
<td>39.64%</td>
</tr>
<tr>
<td>10/03</td>
<td>Genitope</td>
<td>7.0</td>
<td>$9.00</td>
<td>$33.3 M</td>
<td>$33.30 M</td>
<td>89%</td>
<td>11.11%</td>
<td>11.11%</td>
<td>(61.00%)</td>
<td>61.00%</td>
</tr>
<tr>
<td>08/04</td>
<td>New River Pharm.</td>
<td>8.0</td>
<td>$8.00</td>
<td>$33.6 M</td>
<td>$33.60 M</td>
<td>98%</td>
<td>(6.25%)</td>
<td>6.25%</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>03/05</td>
<td>Bofi Holding</td>
<td>6.0</td>
<td>$11.50</td>
<td>$35.1 M</td>
<td>$35.10 M</td>
<td>82%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>05/05</td>
<td>Morningstar</td>
<td>21.0</td>
<td>$18.50</td>
<td>$140.8 M</td>
<td>$140.80 M</td>
<td>65%</td>
<td>8.38%</td>
<td>8.38%</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>07/05</td>
<td>Cryocor</td>
<td>5.0</td>
<td>$11.00</td>
<td>$40.8 M</td>
<td>$40.80 M</td>
<td>59%</td>
<td>(1.18%)</td>
<td>1.18%</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>09/05</td>
<td>Avalon Pharm.</td>
<td>6.0</td>
<td>$10.50</td>
<td>$28.9 M</td>
<td>$28.90 M</td>
<td>---</td>
<td>(9.62%)</td>
<td>9.62%</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>11/05</td>
<td>Dover Saddlery</td>
<td>7.0</td>
<td>$10.00</td>
<td>$27.5 M</td>
<td>$27.50 M</td>
<td>---</td>
<td>2.50%</td>
<td>2.50%</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>01/06</td>
<td>Traffic.com</td>
<td>8.0</td>
<td>$12.00</td>
<td>$78.6 M</td>
<td>$78.60 M</td>
<td>---</td>
<td>1.25%</td>
<td>1.25%</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>01/06</td>
<td>FortuNet</td>
<td>17.0</td>
<td>$9.00</td>
<td>$22.5 M</td>
<td>$22.50 M</td>
<td>---</td>
<td>0.56%</td>
<td>0.56%</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>MEDIAN</td>
<td></td>
<td>7.0</td>
<td>$10.50</td>
<td>$33.3 M</td>
<td>$33.30 M</td>
<td>77%</td>
<td>0.56%</td>
<td>3.93%</td>
<td>(3.33%)</td>
<td>61.00%</td>
</tr>
<tr>
<td>MEAN</td>
<td></td>
<td>10.0</td>
<td>$11.38</td>
<td>$42.2 M</td>
<td>$41.42 M</td>
<td>77%</td>
<td>15.16%</td>
<td>20.29%</td>
<td>1.44%</td>
<td>68.92%</td>
</tr>
</tbody>
</table>

---

OpenIPO Date, Price, Amount, and Gross Proceeds data are from W.R. Hambrecht + Co., [http://www.wrhambrecht.com/ind/auctions/completed.html](http://www.wrhambrecht.com/ind/auctions/completed.html) (last visited Jan. 2, 2007). Firm Age data from Patrik Louko, *Initial Public Offerings and Online IPO Auctions–Significant Advantages in Pricing?* (2006), available at [http://www.pafis.shh.fi/graduates/patlou02.pdf#search=%22pro%20rata%20distribution%20traffic.com%22](http://www.pafis.shh.fi/graduates/patlou02.pdf#search=%22pro%20rata%20distribution%20traffic.com%22). Pro Rata data are courtesy of an e-mail from Matthew Regan, Director of Brokerage Services, W.R. Hambrecht + Co., to Peter B. Oh, Associate Professor of Law (Aug. 22, 2005) (on file with author). Three-Year Return data for Andover.net, Nogatech, and Ravenswood are for less than three years, as Andover.net, and Ravenswood were acquired by other corporations, respectively, in June, 2000 and July, 2001, and Nogatech merged with another corporation in October, 2000. Absolute means and medians are based on over- and under-pricing being equal reflections of inefficiency. The standard deviation for the real First-Day Return is 61.65% and for the real Three-Year Return is 98.35%.

---

As a preliminary matter, there are significant caveats to the data. The paucity of OpenIPOs obviously accords each firm unduly significant weight. For instance, some might exclude Andover.net’s first-day return as an outlier, such exclusion, however, lacks a principled basis. The better approach instead is to regard the OpenIPO data as just a small statistical sample with a limited capacity to support causal inferences—either for or against Dutch IPOs. Moreover, the data include OpenIPOs within the anomalous internet bubble, when investors and venture capitalists were particularly exuberant. While bubble OpenIPOs did outperform all IPOs in first-day returns, both groups experienced extremely severe underpricing that says more about the period than any particular method.

In any event the performance of OpenIPOs is mixed. Bill Hambrecht has said that ‘an auction with a first-day pop of 10% or more is a failure.” By Hambrecht’s measure, then, the average OpenIPO has failed. The mean underpricing for all OpenIPOs is 15.16%, or 20.29% in absolute terms, and 23.53% of the time there has been a first-day pop greater than 10%. Moreover, 66.67% of all OpenIPOs have

---

183 Excluding Andover.net results in an aggregate first-day return median of .47% and mean of 1.32%. But see infra note 184 and accompanying text.

184 See, e.g., Bruno Biais & Anne Marie Faugeron-Crouzet, IPO Auctions: English, Dutch, . . . French, and Internet, 19 J. FIN. INTERMEDIATION 1, 5 (2001) (noting that Andover.net’s “OpenIPO actually set the IPO price at a significant discount relative to the market clearing price, more in line with the rules governing the book building or the Mise en Vente than with those of the Dutch auction”). See also Berkeley et al., supra note 178, at 242 (reporting that Andover.net lowered its clearing price “to reduce the possibility of after market disappointment following offering exuberance and in an effort to build a loyal shareholder base”). Like Google, Andover.net appears to have engaged in deliberate underpricing, the very practice for which bookbuilding has been criticized. One reason may be that the first two OpenIPOs conducted by Hambrecht experienced relatively low-first day returns, and thus failed to generate market enthusiasm by satisfying the established norm of a first-day pop. See supra notes 181-182 and accompanying text (Table 3, OpenIPO Data, 1999-2006). Regardless, Andover.net demonstrates that underpricing is not an inherent function of IPO method, and thus the Hambrecht data set should be considered as a whole.

185 See supra notes 133-138 and accompanying text.

186 The four bubble OpenIPOs had a mean first-day return of 57.3%, or 70.6% in absolute terms, versus 63.3% for all bubble IPOs. See supra notes 181-182 and accompanying text (Table 3, OpenIPO Data, 1999-2006). See also Laura S. Unger, Raising Capital on the Internet, 69 U. CIN. L. REV. 1205, 1207-08 (2001) (observing, as an SEC Commissioner during the height of the internet bubble, that the doubling of Peet’s Coffee & Tea’s stock during the first week of trading, while “belying the notion that an auction ensures that the issuing company raises the maximum amount of money that the market will bear,” also “perhaps prov[es] that secondary market in IPOs is still vigorous.”).

187 That same caution applies to the post-bubble OpenIPOs, whose 2.2%, or 4.8% absolute, mean first-day return outperformed the 11.3% mean of all post-bubble IPOs, but are more meaningful as reflections of the period’s generally scarce venture capital and downturn in IPOs. See supra note 132 and accompanying text.

188 Hurt, What Google Can’t Tell Us, supra note 27, at 428. Arguably the benchmark should be Hambrecht’s commission rate. Cf. Loughran & Ritter, supra note 118, at 8 (“[G]iven the use of bookbuilding, the joint hypothesis that issuers desire to maximize their proceeds and that underwriters act in the best interests of issuers can be rejected whenever average underpricing exceeds [the standard commission rate of] seven percent.”).

189 See supra note 181.

190 Over the same time frame all IPOs had a first-day return of 43.9%.
experienced negative three-year returns, with a mean of 1.44%, or 68.92% in absolute terms.

Even more revealing are the returns once bubble IPOs are excluded. The five non-bubble OpenIPOs experienced a mean first-day return of 2.2%, only slightly outperforming the 7.7% mean for all IPOs during that period. Further, the non-bubble OpenIPOs experienced a mean three-year return of 22.8%, which was greater than the 20.4% for all IPOs during that period; and 60% of the OpenIPOs experienced negative three-year returns, with an absolute mean of 102.3%.

Rearranging the OpenIPO data generates some valuable insights. The average OpenIPO involved a firm that is 10.0 years old with a relatively modest $11.38 offering price and $52.2 million offering amount. Table 4A summarizes OpenIPO returns based on whether the firms were above or below the mean age:

<table>
<thead>
<tr>
<th>GROUP</th>
<th>FIRST-DAY (%)</th>
<th>THREE-YEAR (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Real</td>
<td>Absolute</td>
</tr>
<tr>
<td>Above Mean</td>
<td>7.5</td>
<td>7.5</td>
</tr>
<tr>
<td>Below Mean</td>
<td>17.5</td>
<td>24.0</td>
</tr>
<tr>
<td>All OpenIPOs</td>
<td>15.2</td>
<td>20.3</td>
</tr>
</tbody>
</table>

Younger firms thus experienced a higher average first-day return than their older peers or all firms. Conversely, younger firms experienced a lower average three-year return than their older peers or all firms. This is hardly surprising in that younger firms may be less known commodities that bidding investors fail to value accurately, and that are more susceptible to first-day investor exuberance.

Far more illuminating is the extent to which the returns correlate with the size and robustness of an OpenIPO. Tables 4B, 4C, and 4D summarize OpenIPO returns based on, respectively, Offering Price, Offering Amount, and Gross Proceeds:

---

191 See supra notes 181-182 and accompanying text (Table 3, OpenIPO Data, 1999-2006).

192 Ritter, supra note 1, at 9. The comparison of three-year returns includes OpenIPO firms that were either acquired or merged beforehand, see supra note 181, and obviously does not include any post-2003 IPOs.

193 Once Morningstar, the only OpenIPO raising more than $100 million (and almost $100 million more than the mean), is excluded, the profile becomes a quite humble 9.3 year-old firm with an offering price of $10.94 and offering amount of $36.0 million. As a reference point, from 1983-2002 the average IPO involved a firm that was 18.6 years old, Jason Fink et al., Firm Age and Fluctuations in Idiosyncratic Risk 31 tbl. 2 (May 2004), available at http://ssrn.com/abstract=891173, and shares since the Great Depression tend to be nominally priced at $35.00, see, e.g., Shlomo Benartzi et al., The Nominal Price Puzzle (2006), available at http://ssrn.com/abstract=891213.
TABLE 4B
MEAN OPENIPO RETURNS BY OFFERING PRICE

<table>
<thead>
<tr>
<th>GROUP</th>
<th>FIRST-DAY (%)</th>
<th>THREE-YEAR (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Real</td>
<td>Absolute</td>
</tr>
<tr>
<td>Above Mean</td>
<td>34.9</td>
<td>41.0</td>
</tr>
<tr>
<td>Below Mean</td>
<td>1.3</td>
<td>5.8</td>
</tr>
<tr>
<td>All OpenIPOs</td>
<td>15.2</td>
<td>20.3</td>
</tr>
</tbody>
</table>

TABLE 4C
MEAN OPENIPO RETURNS BY OFFERING AMOUNT

<table>
<thead>
<tr>
<th>GROUP</th>
<th>FIRST-DAY (%)</th>
<th>THREE-YEAR (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Real</td>
<td>Absolute</td>
</tr>
<tr>
<td>Above Mean</td>
<td>87.4</td>
<td>87.4</td>
</tr>
<tr>
<td>Below Mean</td>
<td>(0.3)</td>
<td>5.9</td>
</tr>
<tr>
<td>All OpenIPOs</td>
<td>15.2</td>
<td>20.3</td>
</tr>
</tbody>
</table>

TABLE 4D
MEAN OPENIPO RETURNS BY GROSS PROCEEDS

<table>
<thead>
<tr>
<th>GROUP</th>
<th>FIRST-DAY (%)</th>
<th>THREE-YEAR (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Real</td>
<td>Absolute</td>
</tr>
<tr>
<td>Above Mean</td>
<td>60.0</td>
<td>70.8</td>
</tr>
<tr>
<td>Below Mean</td>
<td>1.4</td>
<td>4.7</td>
</tr>
<tr>
<td>All OpenIPOs</td>
<td>15.2</td>
<td>20.3</td>
</tr>
</tbody>
</table>

Firms featuring an Offering Price and Amount, as well as Gross Proceeds, above the mean all experience first-day returns greater than those below the mean and the entire group. Moreover, underpricing correlates with all of these variables to a greater extent than with firm age.

These Tables collectively suggest the presence and effect of unsophisticated bidding. As a preliminary matter, firms above the mean in all of the Tables experienced increases in average first-day and three-year returns. Of all the variables, Offering Amount featured the highest first-day returns for firms above that mean, as well as the lowest first-day returns for firms below that mean. This is notable because Offering Amount and Firm Age are the only two variables that prospective OpenIPO investors know in advance of submitting their bids. To the extent such information might function as a simple proxy for firm
quality, the accuracy of OpenIPO investors’ judgments should be manifest in a lower degree of returns. Instead, the positive correlation between the Offering Amount and the first-day returns comports with studies that have found larger auctions tend to introduce more risk-seeking or uninformed participants.

This is corroborated by the Offering Price return data. Prior to submitting bids OpenIPO investors do not know what the Offering Price will be. Nevertheless, the Offering Price does represent a funnel of investors’ judgments about the firm, fellow investors’ judgments, and general market conditions. Presumably investors with access to superior information or tools enjoy a superior position to gauge the ultimate Offering Price. The sizable positive first-day returns, however, suggests that the Offering Price has been difficult to gauge or that the judgments of less sophisticated investors have had a greater net impact.

In sum domestic auction-based IPOs have hardly distinguished themselves from their bookbuilt counterparts. The levels of underpricing in both IPO methods seem to be relatively comparable. The problem is that auction-based IPOs, according to their proponents, should not be producing the same level of underpricing as bookbuilding. Despite a paucity in data, OpenIPOs seem to suffer from inaccurate pricing due to an influx of unsophisticated bids; in essence, using an auction seems to

194 See, e.g., Anand, supra note 106, at 243 (“Retail shareholders . . . have a greater impact on pricing in a Dutch auction than they would have in a traditional underwritten offering. Because of their lack of sophistication, these investors can make the market less efficient.”). A more common proxy is underwriter quality, but that does not apply here, as there is no reputational assurance from a firm commitment or best efforts arrangement.

195 This is less so with bookbuilding because a degree of underpricing is acceptable, if not preferred, and thus the first-day returns reflect the underwriters’ pricing judgment.

196 See, e.g., Rock, supra note 52, at 189 (predicting that “the greater the uncertainty about the true price of the new shares, the greater the advantage of the informed investors and the deeper the discount the firm must offer to entice uniformed investors into the market”); see also generally Ann E. Sherman, Global Trends in IPO Methods: Book Building Versus Auctions with Endogenous Entry (Dec. 2004) (finding auctions with larger pools of bidders are susceptible to more inaccurate pricing), available at http://ssrn.com/abstract=276124. This is merely one possible explanation, as the correlation between Offering Size and Returns is tenuous given the paucity of OpenIPOs.

197 This is only complicated by the fact that the offering price is not necessarily equal to the clearing price, or the lowest price that will sustain the entire allotment of shares. Hambrecht reserves the right to fix an offering price that is different than the clearing price. See infra note 172 and accompanying text. Moreover, given the relative novelty of this procedure within the U.S., unsophisticated investors are highly unlikely to be able to project what the ultimate offering price will be.

198 Demographic data for OpenIPO investors are not available, but would facilitate a sense of the proportion of individual versus institutional investors to permit a better portrait of the bidding pool’s relative sophistication.

199 Auction-based IPOs, however, do seem more prone to lose their value dramatically over a three-year span. See supra notes 181-182 and accompanying text (Table 3, OpenIPO Data, 1999-2006). This merely contributes to the suspicion that auction-based IPOs tend to appeal more to nascent firms seeking a way to generate additional publicity for their equity-raising effort. Cf. Berkeley et al., supra note 178, at 242 (“Of course, companies that select the Dutch auction approach are likely to self-select and be predisposed to the approach for collateral social reasons, be attracted by the novelty, and be willing to extend it extra tolerance.”).
introduce different problems that produce results quite comparable to and better justified by bookbuilding.

B. International Auction-Based IPOs

The results of domestic auction-based IPOs are in line with what the world has known for some time. Well before 1999, when Hambrecht unveiled its OpenIPO platform, a substantial number of countries already had experimented with auction-based IPOs and abandoned them in favor of some form of bookbuilding.200 Moreover, when given a choice between an auction-based IPO or bookbuilding, foreign issuers overwhelmingly have preferred the latter.201 As a prominent finance scholar has observed, “[a]round the world, auctions have fallen out of favor” as a way to go public.202

A survey of 50 countries identifies 23 that have experimented with an auction-based IPO method.203 Currently, five countries no longer permit the method, and 13 countries effectively have abandoned it.204


201 See Jagannathan & Sherman, supra note 141, at 56-7 tbl. 1.

202 Ruth Simon & Elizabeth Weinstein, Investors Eagerly Anticipate Google’s IPO - Dutch Auction-Type Process May Give Smaller Bidders a More Level Playing Field, Apr. 30, 2004, WALL ST. J., at C1 (quoting Alexander Ljungqvist, Associate Professor of Finance, New York University Leonard N. Stern School of Business); see also Ann E. Sherman, IPOs and Long-Term Relationships: An Advantage of Bookbuilding, 13 REV. FIN. STUD. 697, 697 (2000) (noting “[t]here is an international trend toward use of the U.S. book-building (firm commitment) method for initial public offerings” and “that auctions have not been more popular” [globally]). This is especially notable in that underpricing appears to be an even more pervasive problem within international equity markets. See, e.g., Galbraith et al., supra note 71, at 31-32 (“Within world markets the underpricing averages tend to be somewhat higher—a result that is often explained by differences in the perceived risk between domestic and international markets.”). See also generally Thomas J. Boulton et al., International IPO Underpricing and Investor Protection (2006) (finding mean first-day return of 30.5% for 4,698 IPOs in 24 countries from 2000-2004 examining corporate governance variables), available at http://ssrn.com/abstract=928526.

203 Jagannathan & Sherman, supra note 141, at 56-7 tbl. 1. Included within this figure are Germany and Spain, each of which reportedly has experienced only two auction-based IPOs, as well as Finland and Kenya, each of which allows fixed-price auctions. Id. Jagannathan and Sherman also include within their survey pure fixed-price offerings as well as fixed-price and bookbuilding hybrids. While these are prominent IPO methods, they are omitted here as they can be used with auctions or bookbuilding, and so do not directly bear on which method of price discovery is superior. In any event, bookbuilding appears to generate higher expected proceeds than fixed-price offerings. See generally Lawrence M. Benveniste & William J. Wilhelm, A Comparative Analysis of IPO Proceeds Under Alternative Regulatory Regimes, 28 J. FIN. ECON. 173 (1990). But see generally Lawrence M. Benveniste & Walid Y. Busaba, Bookbuilding v. Fixed Price: An Analysis of Competing Strategies for Marketing IPOs, 32 J. FIN. & QUANT. ANAL. 383 (1997).

204 See Jagannathan & Sherman, supra note 141, at 56-7 tbl. 1 (identifying Argentina, Australia, Germany, Italy, and Sweden as no longer permitting auction-based IPOs, and Brazil, Peru, Poland, South Korea, and the United States as continuing to permit some form of auction-based IPOs). In all of these countries that permit auction-
Instead, bookbuilding is now either growing in acceptance or already the dominant method for issuers in 14 countries; auction-based IPOs are the dominant method in only one country, Israel, which prohibited the use of bookbuilding until just this year.

Indeed, Israel is the only reported country that has been an exclusive auction-based IPO regime. Like the OpenIPO, Israeli auctions are open to all types of prospective investors, who know the total number of shares and minimum acceptable price via a prospectus. Without any commission, these investors submit their bids, and, unlike the OpenIPO, the clearing price is the final offering price. In these respects, then, Israel provides an opportunity to examine the efficiency of a quite pure auction-based IPO.

There are three prominent studies of Israeli auction-based IPOs. Table 5 summarizes these studies’ findings:

<table>
<thead>
<tr>
<th>STUDY</th>
<th>SCOPE</th>
<th>SAMPLE</th>
<th>MEAN</th>
<th>MEDIAN</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amihud et al.</td>
<td>1989-93</td>
<td>284</td>
<td>12.0%</td>
<td>6.6%</td>
</tr>
<tr>
<td>Hauser et al.</td>
<td>1992-96</td>
<td>53</td>
<td>(5.3%)</td>
<td>---</td>
</tr>
<tr>
<td>Kandel et al.</td>
<td>1993-96</td>
<td>27</td>
<td>4.1%</td>
<td>---</td>
</tr>
</tbody>
</table>

Beyond featuring the most comprehensive sample, the study by Amihud et al. also eschews two significant events. For a number of years Israeli issuers could announce just a minimum price or an acceptable price range, with the offering price in either case being determined by an auction; in December, 1993, however, the option of announcing a

---

205 The only truly competing alternative is some variant of a fixed-price offering. See supra note 203.

206 Id. at 56-7.


208 Id.

209 Yakov Amihud et al., Allocations, Adverse Selection, and Cascades in IPOs: Evidence from the Tel Aviv Stock Exchange, 68 J. FIN. ECON. 137, 145 tbl. 2 (2003) (reporting t-value of 7.2%). Thirty-nine of the IPOs were fixed-price auctions, in which the issuer pre-announced a minimum and maximum price. See infra note 203 and accompanying text.

210 Shmuel Hauser et al., Initial Public Offering Discount and Competition, 49 J.L. & ECON. 331, 338 (2006) (reporting t-value of 4.3%).

211 Kandel, supra note 207, at 238 tbl. 3 (reporting standard deviation of 11.3%).

212 Hauser et al., supra note 210, at 332.
price was eliminated.\footnote{Amihud et al., supra note 209, at 141; see also Hauser et al., supra note 210, at 332-33 (citing “reaction to frequent herding of bids at the binding maximum price and consequent severe rationing and uncertain share allocations . . .”).} And, at the end of February, 1994, the Tel Aviv Stock Exchange crashed, which had a precipitous effect on IPOs.\footnote{See Kandel et al., supra note 207, at 231 n.4 (“Following the crash there was a dramatic decline in IPO activity and almost all the issues offered after the crash were sold at the minimum price set in the offers’ prospectuses.”).}

Nevertheless, the studies bear collective results that roughly comport with the OpenIPO data. First, a significant portion of Israeli issuers experienced negative first-day returns, ranging from 33.3\% to 44.4\%,\footnote{Compare Amihud et al., supra note 209, at 143; Kandel et al., supra note 207, at 245; with supra notes 181-182 and accompanying text (Table 3, OpenIPO Data, 1999-2006); see also Amihud et al., supra note 209, at 143 (finding that Israeli IPO returns changed minimally over the initial five months, and suggesting “that the market prices the issued units efficiently immediately after the IPO and that the initial return is not a result of fad or overreaction.”). Smaller successful bids also experienced negative first-day returns. See, e.g., Hauser et al., supra note 210, at 341-42. Amihud et al. use the allocation rate as a proxy for uninformed investors on the basis that shares are awarded mechanically to all parties. See, e.g., Amihud et al., supra note 209, at 138 (finding “the IPOs were slightly overpriced for uninformed investors, or that the demand of these investors for IPOs was on average too high”). While larger investors are likely to be well-informed, the converse does not necessarily obtain.} which evince overpricing and equity loss. Second, larger IPOs appeared to enjoy greater demand but also result in greater underpricing, which is consistent with an influx of more uncertainty via a more diverse bidding pool.\footnote{See, e.g., Amihud et al., supra note 209, at 149. Amihud et al. interpret this as evidence of possibly deliberate underpricing, on the assumption “that new issues are underpriced by more than is necessary to offset the negative effects of large size and uncertainty,” id., but a larger bidding pool may actually result in upward pricing effects.} Finally, a number of the studies tested for the effects of cascading, in which prospective investors imitate each other and thus generate artificial increases in demand;\footnote{See generally Ivo Welch, Sequential Sales, Learning, and Cascades, 47 J. Fin. 137 (1992).} these tests tend to demonstrate that Israeli bidders who are better-informed about the potential rates of subscription, and thus allocation, tend to make superior decisions about when and how to invest in an auction-based IPO.\footnote{See, e.g., Amihud et al., supra note 209, at 155 (finding relatively laid investors could improve their performance by discerning other investors’ strategies); Hauser et al., supra note 210, at 341 (finding investors can benefit by avoiding weaker issues and being more selectively with price).}

Far more illuminating than an exclusive regime,\footnote{Nine countries that have abandoned auction-based IPOs entirely in favor of bookbuilding. See Jagannathan & Sherman, supra note 141, at 4 (identifying Argentina, Italy, Malaysia, Portugal, Singapore, Sweden, Switzerland, Turkey, and the United Kingdom). The decision to switch methods, however, may be motivated by any number of reasons, some of which may be independent of economic merit.} however, are countries that have provided issuers a choice of diverse methods. For instance, since 1989, Japanese issuers were restricted to only an auction-
based method; but once bookbuilding became available in 1997, that method quickly became the preferred choice.\footnote{Id.; see also generally Richard Pettway & Takashi Kaneko, The Effects of Removing Price Limits and Introduction of Auctions upon Short-Term IPO Returns: The Case of Japanese IPOs, 4 PACIFIC-BASIN FIN. J. 241 (1996).}

Besides Israel, only France and Taiwan still offer a choice between bookbuilding and an auction-based method.\footnote{This paper does not examine Taiwanese IPOs, as they are peculiar in a number of significant respects. First, Taiwanese issuers typically do not conduct initial public offerings due to regulatory scrutiny; instead, “it is a common practice, when new funds are needed, for the company to issue more shares to existing stockholders who then sell those shares in the IPO itself.” Yao-Min Chain et al., Underpricing, Partial Adjustment and the Effects of Entry on Taiwan’s IPO Auctions 17 n.22 (Oct. 2006), available at http://www.nd.edu/~finance/020601/news/Ann%20Sherman%20Paper%20-%202006.pdf. Second, Taiwanese auction-based IPOs are conducted in two stages, consisting of a competitive discriminatory auction for 50% of the issue to certain preferred bidders followed by an offering of the remaining shares to the general public at a price capped at 1.5 times the reserve price; bidders at both stages also face caps in the number of possible allocable shares. See, e.g., An-Sing Chen et al., Price Support in Taiwan IPO Stock Auctions 7-9 (Jan. 2005), available at http://www.fma.org/Chicago/Papers/PriceSupport13.pdf; Ji-Chai Lin et al., Why Have Auctions Been Losing Market Shares to Bookbuilding in IPO Markets? 8-9 (June 2003), available at http://ssrn.com/abstract=410183. In any event, according to one study, “Taiwanese auctions are not necessarily better at incorporating more recent market information into the IPO price . . . .” Yenshan Hsu & Chung-Wen Hung, Why Have IPO Auctions Lost Market Share to Fixed-Price Offers? Evidence from Taiwan 4 (Aug. 2005) (finding mean first-day return of 21.1% for 84 Taiwanese IPOs from 1995 to 2000), available at http://www.fma.org/Chicago/Papers/ IPO_methods.pdf.}

Of these countries, France is the most mature auction-based regime, having permitted the method since the 1960s.\footnote{See, e.g., John G. McDonald & Bertrand C. Jacquillat, Pricing of Initial Equity Issues: The French Sealed-Bid Auction, 47 J. BUS. 37, 37 (1974) (“In France all initial issues of common stock since 1964 have been priced and allocated in a sealed-bid auction procedure . . . .”).} French issuers have a choice between bookbuilding, known as the \textit{Placement Garanti}, and a variant of the dirty Dutch IPO, known as the \textit{Mise en Vente}.\footnote{Biais & Faugeron-Crouzet, supra note 184, at 12. As with Israel, France offers a choice of three IPO types: \textit{Placement Garanti}, or orthodox bookbuilding; \textit{Offre à prix ferme}, or fixed-price auction; and \textit{Mise en Vente} or \textit{Offre à prix minimal}, or French auction. See, e.g., Bruno Husson & Bertrand Jacquillat, French New Issues, Underpricing and Alternative Methods of Distribution, in A REAPPRAISAL OF THE EFFICIENCY OF FINANCIAL MARKETS 349, 351 (Rui M. C. Guimarães et al., eds., 1989). This paper only focuses on the choice between the \textit{Placement Garanti} and \textit{Mise en Vente}. See supra note 203.} In this type of an auction the issuer meets with investment banks to set the final offering amount approximately a week before the IPO.\footnote{See, e.g., Bruno Biais et al., An Optimal IPO Mechanism, 69 REV. ECON. STUD. 117, 119 (2001) (“[T]he firm sets a reservation price and investors submit bids.”).} Unlike the OpenIPO, however, the \textit{Société des Bourses Françaises}, which is France’s equivalent to the SEC, processes the investors’ bids and converts them into a demand curve.\footnote{See, e.g., Husson & Jacquillat, supra note 223, at 351 (“[T]he banks and the brokers gather the bids . . . and transmit them to the ‘\textit{Société des Bourses Françaises}’ (the governing body of the Paris Bourse . . .) which centralizes and process the bids.”).} Then, on the day of the IPO, the issuer sets a minimum and maximum price for all investors, while the issuer’s investment bank
remains in the background, prepared to purchase or sell the securities if their price requires stabilization. Oversubscribed offerings can result in a postponement of the IPO or allocation on a pro rata basis.

There are four prominent studies of the Mise en Vente. Table 6A summarizes these studies’ findings:

<table>
<thead>
<tr>
<th>Study</th>
<th>Scope</th>
<th>Sample</th>
<th>Mean First-Day Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>Derrien &amp; Womack</td>
<td>1992-98</td>
<td>99</td>
<td>9.7%</td>
</tr>
<tr>
<td>Belletante &amp; Paliard</td>
<td>1984-91</td>
<td>165</td>
<td>20.7%</td>
</tr>
<tr>
<td>Biais &amp; Faugeron-Crouzet</td>
<td>1983-96</td>
<td>92</td>
<td>13.0%</td>
</tr>
<tr>
<td>Husson &amp; Jacquillat</td>
<td>1983-86</td>
<td>47</td>
<td>35.9%</td>
</tr>
</tbody>
</table>


227 Husson & Jacquillat, supra note 223, at 351 (finding 20 out of 99 Mise en Ventes from 1992 to 1998 were postponed due to excessive demand).


229 The Biais & Faugeron-Crouzet and Husson & Jacquillat studies concern only the Second Marché, an intermediary securities tier with less stringent listing requirements than the Cotefficcielle. Biais & Faugeron-Crouzet, supra note 184, at 23; Husson & Jacquillat, supra note 223, at 354. The Sample data refer to the number of Mise en Ventes examined, except for the Belletante & Paliard study, which is not available in English.

230 Derrien & Womack, supra note 226, at 36 (reporting standard deviation of 12.3% and median of 6.3%). Over the same period the Placement Garanti had a mean first-day return of 16.89%, with a standard deviation of 24.5%. Id. French underwriters, however, conduct road shows and meetings with investors over a markedly more compressed timeframe than their U.S. counterparts do. Id. at 37. Moreover, French firms “tend to choose their regular bank as their lead underwriter,” in contrast to the competitive beauty pageant that is a hallmark, and arguably a strength, of American underwriters. Id. at 58.


232 Biais & Faugeron-Crouzet, supra note 184, at 24 (reporting standard deviation of 16.5%).

233 Husson & Jacquillat, supra note 223, at 355 & 360 (reporting standard deviation of 3.4% for non-adjusted return).
These returns may be best described by Biais and Faugeron-Crouzet, who conclude that the *Mise en Vente* experiences underpricing “very similar to those [underpricing levels] observed in the United States in the context of the Book Building procedure.” Indeed, for three of the four studies, the mean underpricing for U.S. bookbuilt IPOs outperformed the *Mise en Vente*.

Cross-country comparisons, however, are unnecessary. A simple comparison of mean first-day returns between the *Mise en Vente* and *Placement Garanti* would suffice:

### TABLE 6B
**FRENCH AUCTION V. BOOKBUILDING RETURNS**

<table>
<thead>
<tr>
<th>STUDY</th>
<th>SCOPE</th>
<th>MISE EN VENTE (%)</th>
<th>PLACEMENT GARANTI (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Derrien &amp; Womack</td>
<td>1992-98</td>
<td>9.7%</td>
<td>16.9%</td>
</tr>
<tr>
<td>Belletante &amp; Paliard</td>
<td>1984-91</td>
<td>16.4%</td>
<td>4.3%</td>
</tr>
<tr>
<td>Husson &amp; Jacquillat</td>
<td>1983-86</td>
<td>35.9%</td>
<td>10.5%</td>
</tr>
</tbody>
</table>

As a preliminary matter, none of the studies evince that the *Mise en Vente* effectively eliminates underpricing, which should be the proper standard. Further, two of the studies reveal that, on average, the *Mise en Vente* not only fails Bill Hambrecht’s standard of 10% returns, but also dramatically exceeds that of the *Placement Garanti*. These experiences seem consistent with French issuers’ choice of method, as summarized in Table 6C, which covers the same time span as the studies:

---

235 For the period examined by Derrien & Womack, the U.S. mean was 14.8%; for the period examined by Belletante & Paliard, the U.S. mean was 6.7%; for the period examined by Biais and Faugeron-Crouzet, the U.S. mean was 10.9%; and for the period examined by Husson and Jacquillat, the U.S. mean was 6.5%. See Ritter, *supra* note 1, at 9.
236 Biais and Faugeron-Crouzet do not provide underpricing data for the *Placement Garanti*.
237 Derrien & Womack, *supra* note 226, at 36 (reporting standard deviation of 24.5% for *Placement Garanti*).
238 Leleux, *supra* note 231, at 85. These are the market-adjusted returns for both the *Mise en Vente* and *Placement Garanti*, as the non-adjusted returns are not available.
Table 6C

**FRENCH CHOICE OF IPO METHOD**

<table>
<thead>
<tr>
<th>YEAR</th>
<th>OFFRE À PRIX FERME (%)</th>
<th>MISE EN VENTE (%)</th>
<th>PLACEMENT GARANTI (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983-1984</td>
<td>9 (32.1)</td>
<td>8 (28.6)</td>
<td>11 (39.3)</td>
</tr>
<tr>
<td>1985-1986</td>
<td>15 (26.3)</td>
<td>39 (68.4)</td>
<td>3 (5.3)</td>
</tr>
<tr>
<td>1987-1988</td>
<td>37 (52.1)</td>
<td>13 (18.3)</td>
<td>21 (34.4)</td>
</tr>
<tr>
<td>1989-1990</td>
<td>20 (60.6)</td>
<td>6 (18.2)</td>
<td>7 (21.2)</td>
</tr>
<tr>
<td>1991-1992</td>
<td>4 (44.4)</td>
<td>4 (44.4)</td>
<td>1 (11.1)</td>
</tr>
<tr>
<td>1993-1994</td>
<td>12 (33.3)</td>
<td>12 (33.3)</td>
<td>12 (33.3)</td>
</tr>
<tr>
<td>1995-1996</td>
<td>6 (10.5)</td>
<td>31 (54.4)</td>
<td>20 (35.1)</td>
</tr>
<tr>
<td>1997-1998</td>
<td>4 (3.0)</td>
<td>47 (35.3)</td>
<td>82 (61.7)</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>107 (24.9)</strong></td>
<td><strong>162 (38.8)</strong></td>
<td><strong>160 (37.3)</strong></td>
</tr>
</tbody>
</table>

Over this 16-year period the *Mise en Vente* (38.8%) has been the most popular method, but only by a slight margin over the *Placement Garanti* (37.3%), which has enjoyed increasing popularity over the past decade. Both methods appear to enjoy prominence at the expense of the fixed-price method. To be sure, the choice of method involves a wide variety of variables involving the specific firm’s attributes and the general financial climate. But French issuers clearly seem to be gravitating towards a bookbuilt IPO, which seems to no less, if not more, efficient than the *Mise en Vente*.

In sum the empirical data hardly establish the superiority of auction-based IPOs to traditional bookbuilding. On the contrary underpricing appears to be correlated directly with the offering size of OpenIPOs, which tend to lose their value significantly over the long-run. These trends comport with a portrait of younger, smaller companies seeking publicity from this relatively novel IPO method. And with the benefit of more extended and sizable auction-based experience, foreign countries and issuers clearly seem to realize the merits of bookbuilding. Comprehensive domestic data eventually may become available to test these tentative conclusions. At the very least, however, the data

---


241 After 1998 the French regulatory landscape changed dramatically. In 2000 the Paris Bourse announced its intent to merge with the Amsterdam and Brussels stock exchanges to form Euronext, an integrated securities market; and in 2003 French financial regulatory authorities were consolidated into one entity, the Autorité des marchés financiers (AMF). *See generally AMF ANNUAL REPORT 2004*, http://www.amf-france.org/documents/general/6393_1.pdf.
III. Sophisticated Auction Behavior

The previous Parts evaluated the case against bookbuilding and for auction-based IPOs. Both methods are best understood as a device for issuers to resolve asymmetrical information problems. Auctions collect bidders’ valuations while sidestepping collective bargaining problems by presuming the seller has all of the negotiating power. This power comes in the form of the seller’s unilateral ability to select an auction type and a set of policies in advance.

Auctions, however, are uniquely susceptible to strategic behavior. Simply by reducing their demand, bidders can manipulate the price of shares and then turn a profit in the aftermarket. Further, by exchanging information and analyzing past IPOs, bidders can collude with each other. Unfortunately, in neither case can such manipulation or collusion be easily detected. This Part delineates some fundamental principles of auctions before demonstrating how they can be undermined through sophisticated behavior.

A. Manipulative Bidding

Constructing an optimal Dutch IPO model is a matter of elementary auction theory. Although there is a diverse array of auction types, they are all governed by the Revenue Equivalence Theorem (RET), which provides:

Assume each of a given number of risk-neutral potential buyers has a privately-known signal [or valuation] independently drawn from a strict-increasing atomless distribution. Then any mechanism in which (i) the object always goes to the buyer with the highest signal [or valuation], and (ii) any bidder with the lowest-feasible signal [or valuation] expects zero surplus, yields the same expected revenue (and results in each bidder

---

242 A more fundamental question, beyond the scope of this paper, is whether greater democracy in the IPO process is desirable. See generally Anand, supra note 106, at 233 (cautioning against Dutch IPO’s inclusion of unsophisticated retail investors and contending that offering markets, when understood as a public good, already are well-protected by existing fiduciary duties). Anand persuasively argues that completely displacing bookbuilding with Dutch IPOs is unnecessary (if not unjustified), especially when the “most efficient offering mechanism will surely vary by issuer” Id. at __.

243 See, e.g., R. Preston McAfee & John McMillan, Bidding Rings, 82 AM. ECON. REV. 579, 581 (1992) (“The distinctive feature of an auction is asymmetric information; if the seller knew the bidders’ demands, he would simply post a price.”).

making the same expected payment as a function of her signal [or valuation]). 245

Provided the RET’s assumptions obtain, 246 different auction types have been shown to generate the same average revenue. 247

In theory, then, Dutch IPOs should perform like any auction. Specifically, Dutch IPOs should generate Pareto optimal outcomes. 248

Prospective Dutch IPO investors, however, privately submit their bids, and thus do not know each others’ valuations. 249 Under such circumstances, bidders are vulnerable to what is known as the “winner’s curse,” or a feeling of regret experienced by the highest bidder for having paid more than anyone else. 250 Dutch IPOs do not expose their investors to a “winner’s curse” in the orthodox sense, as all successful bids receive shares at a uniform price; instead prospective investors risk their allocations, either by bidding underneath the clearing price or receiving a fractional allocation from an oversubscribed IPO. 251 Whatever the


246 Some of these assumptions need not obtain for certain auction types to yield the same revenue. See, e.g., Vickrey, supra note 250 (demonstrating revenue equivalence for first-price, sealed-bid English auctions and sealed-bid Dutch auctions).

247 McAfee & McMillan, supra note 30, at 710 (“Each of these auction forms yields on average the same revenue to the seller. . . . [But] [t]he Revenue-Equivalence Theorem does not imply that the outcomes of the four auction forms are always exactly the same.”). If supplemented by an optimal reserve price, all of these auction types are equally optimal selling mechanisms for the seller. See, e.g., John G. Riley & William F. Samuelson, *Optimal Auctions*, 71 AM. ECON. REV. 381, 382 (1981) (“[F]or a broad family of auction rules, expected seller revenue is maximized using either of the two common auctions if the seller announces that he will not accept bids below some appropriately chosen minimum or ‘reserve’ price.”). For the bidder the expected revenue equals the winner’s expected marginal revenue. See, e.g., McAfee & McMillan, supra note 30, at 706; cf. Bulow & Roberts, supra note 244, at 1061 (The RET is “essentially equivalent to the analysis of standard monopoly third-degree price discrimination. The auctions problem can therefore be understood by applying the usual logic of marginal revenue versus marginal cost.”).


249 See, e.g., Klempener, supra note 245, at 229 (“In the basic private-value model each bidder knows how much she values the object(s) for sale, but her value is private information to herself.”) (emphasis in original).

250 See generally Vickrey, supra note 248, at 21-22. But see generally James C. Cox & R. Mark Isaac, *In Search of the Winner’s Curse*, 22 ECON. INQ. 579 (1984) (delineating permutations of the winner’s curse and contending that it generally occurs when bidders are not utilizing ex ante optimal strategies). One way to produce a more optimal expected return is to designate the second-highest sealed bid as the winner, otherwise known as a second-price, or Vickrey, auction. Cf. Klemperer, supra note 245, at 266 n.10 (“Confusingly, the second-price sealed-bid auction is sometimes called a Dutch auction by investment bankers.”).

251 See, e.g., Anand, supra note 106, at 243 (“The winner’s curse possibility may lead Dutch auction issuers to deliberately underprice the issue in order to prevent this divestiture and to maintain investor following after the IPO.”).
auction type, to combat the “winner’s curse,” bidders rationally should submit a price less than their own true valuation based upon guesses about other bidders’ valuations, thereby reaching a Nash equilibrium.252

In reality, however, Dutch IPOs deviate significantly from the RET. First, Dutch IPOs involve rather heterogeneous bidding pools. By opening access to both institutional and retail investors, Dutch IPOs admit bids reflecting widely disparate levels of knowledge and sophistication,253 as well as asymmetrical risk-profiles.254 Second, Dutch IPOs involve uncertain bids. By reserving the discretion to de-link the clearing and offering prices, Dutch IPOs complicate the ability of investors to value shares and bid accordingly, resulting in distorted bids.255 Third, this heterogeneity and uncertainty may magnify each other’s effects. Without substantial confidence in how a firm will price (and allocate) its shares, investors have an incentive to hedge their preferences by submitting multiple bids of varying prices (and allocations),256 further, the degree and form of response to such an incentive likely reinforces the differences among bidders, who have varying abilities to capitalize on such uncertainty.257

Auction theory, however, does provide a very real problem with Dutch IPOs. Specifically, bidders can affect market demand by engaging

---

252 See, e.g., McAfee & McMillan, supra note 30, at 708; see also id. at 710 (noting this is a “nontrivial computational problem”).

253 See, e.g., Vickrey, supra note 248, at 17 (“Where there is much variation in the state of information or the general intensity of desire of the various players for the object, or where the bidders are insufficiently sophisticated to discern the equilibrium point strategy . . . the Dutch auction is likely to prove relatively inefficient”). See also Anand, supra note 106, at 243 (“Retail shareholders typically do less research and diligence in making their investment decision than a sophisticated institutional investor.”). While certainly more heterogeneous than bookbuilding, the investing pool in a Dutch IPO may or may not be different than any other auction. But cf. Chris Yung, IPOs with Buy- and Sell-Side Information Production: The Dark Side of Open Sales, 18 REV. FIN. STUD. 327 (2005) (arguing open auctions may result in lower due diligence due to a free rider problem).


255 Neither Google nor Hambrecht has disclosed its pricing (or allocation) formula, unlike other countries. See, e.g., Biais & Faugeron-Crozet, supra note 184, at 14 (mathematically defining Mise en Vente price function). Presumably this is to mitigate the risk of insincere bidding. See infra Part III.B. But see Dorton, supra note 33, at 1391 (“[B]idders in an auction have incentives to value the securities accurately. In an appropriately designed auction, the fear of losing a desirable purchase opportunity discourages undervaluation. Any tendency to overvalue the securities is countered by the fear of paying more than the securities are worth.”).

256 See, e.g., Anand, supra note 106, at 243-44 (delineating different strategic incentives for bidders and issuers that may result in inefficient Dutch IPO pricing).

257 For instance, risk-averse institutional bidders may use their leverage to procure some form of insurance or guarantee. See, e.g., Eric S. Maskin & John G. Riley, Optimal Auctions with Risk Averse Buyers, 52 ECONOMETRICA 1473, 1474 (1984).
in strategic behavior to alter the clearing price. Various models have demonstrated that, “under certain scenarios, . . . a rational bidder will profit from lowering the amount of shares it offers to buy in the IPO.”

By estimating the equilibrium price and market elasticity for an untainted auction, bidders can employ their reduced demand to yield underpriced shares, which they can purchase in the aftermarket. Bidders will engage in such a strategy when the increased utility exceeds the costs of going into the aftermarket and purchasing the remaining shares to meet her original demand.

This reduced allocation strategy should circumvent a Dutch IPO’s primary antifraud devices. The strategy may be difficult to detect because the investor is scaling back its bid on shares rather than prices. A comparison of the prospective investor’s bids across various IPOs is possible, but the information would have to be shared among issuers and the search costs might be prohibitive for a sizable pool. And though a strategic bidder will be most visible while entering the aftermarket to purchase additional shares, “without the bidder trading on the days following the IPO, the restricted strategy cannot be detected . . . .”

258 See, e.g., Biais & Faugeron-Crozet, supra note 184, at 5 (“[T]he optimal strategy of the investors is to shade their bids rather than to ‘make a bid at the maximum price at which they are comfortable owning shares of the issue’ as advised on Open IPO’s website.”).

259 Mira Ganor, A Proposal to Restrict Manipulative Strategy in Auction IPOs 13 (July 2004), available at http://ssrn.com/abstract=522423; see also Biais & Faugeron-Crozet, supra note 184, at 5 (“In [the Dutch] auction, bidders can tacitly collude by placing demand functions such that the market clearing price is very low, and such that, any attempt to bid more aggressively, to gain market share, would push prices too high to be attractive.”).

260 See Ganor, supra note 259, at 17 & 18 n.30 (noting that “[f]airly sophisticated investors, such as investor bankers, are well positioned to calculate” and execute such a strategy, and pointing out that “[s]ome variations on the Dutch IPO auction make it even easier for the investors to calculate these variables”) (citing Hurt, Moral Hazard, supra note 27, at 54 (“During [the Wit Capital Corporation] auction, any Internet user could view the aggregate demand in the auction at each price point, making the pricing of the shares virtually transparent.”)). Conducting an IPO via an auction thus meets the two conditions for profitable manipulation, “first, trading must cause the price of the relevant security to rise; and second, the manipulator must be able to sell at a price higher than the price at which the manipulator purchase.” Daniel R. Fischel & David J. Ross, Should the Law Prohibit “Manipulation” in Financial Markets?, 105 HARV. L. REV. 503, 512 (1991). These conditions pertain to aftermarket trading, but the point here is that an auction introduces the problem of manipulation at the pre-IPO stage in a way that arguably is not self-detering.

261 See Ganor, supra note 259, at 16 (“[T]he strategy always assures a profit. This is because the bidder buys the same amount of shares, only now he does this in two stages—first in the auction and later in the aftermarket -- but he pays a lower price for some of the shares, and he pays the same price he would have paid without the strategy, for the rest of the shares.”).

262 See id. (“[T]he strategy manifests itself only as an offer for fewer shares, and Qn, the real amount the bidder would ask for without the strategy, cannot be proven.”). The same logic applies for lock-up agreements or regulatory restrictions on aftermarket purchases, which would diminish the number of strategic bidders but not eliminate those whose expected utility exceeded the cost of waiting until their right to purchase shares was restored.

263 Id.
And instituting a reserve price is likely to be a risky prophylactic, as this would likely distort the relationship between the demand curve and clearing price.\textsuperscript{264} The strategy, however, may enjoy only limited success with current types of Dutch IPOs.\textsuperscript{265} To be successful, strategic bidders must be assured of receiving an allocation; this is because the strategy requires a precise comparison between the number of shares the bidder would receive in an untainted auction versus what the bidder expects to receive in a tainted auction.\textsuperscript{266} Only when equipped with this knowledge can the strategic bidder profit from reducing the requested allocation.\textsuperscript{267} This is easily accomplished in an ascending-bid auction, as the dominant Pareto strategy is for the bidder with the highest valuation simply to submit the highest price.\textsuperscript{268} In the case of Dutch IPOs, however, allocations are based on an opaque formula in which market demand is just a variable.\textsuperscript{269} Payment is thus not purely a function of bids, and so English and Dutch IPOs cannot be equated pursuant to the RET.\textsuperscript{270} Further, the formula’s opacity, combined with the current paucity of Dutch IPOs, makes reverse-engineering difficult.\textsuperscript{271} This erodes the precision with which bidders can reduce their requested allocations. And given the apparently heterogeneous bidding pools in the OpenIPO,\textsuperscript{272} the ability of strategic bidders to reliably assess market elasticity and predict the final offer price may be dubious.

\textsuperscript{264} As Google demonstrated, altering the clearing price in the eleventh hour can engender heavy trading on the first day, which is a negative signal for a Dutch IPO. See \textit{supra} note 188 and accompanying text.
\textsuperscript{265} The analysis from Ganor as well as Biais and Faugeron-Crozet concerns Dutch IPOs and properly focuses on valuation instead of price. Both of Ganor’s illustrations, however, envision a strategic bidder with the highest valuation of an IPO’s shares, a dramatically more complicated scenario in a Dutch IPO as it involves multiple sealed-bids.
\textsuperscript{266} See \textit{supra} note 258 and accompanying text.
\textsuperscript{267} See \textit{supra} note 261 and accompanying text.
\textsuperscript{268} See Ganor, \textit{supra} note 259, at 10-11, 13-15 (presenting two illustrations in which the strategic bidder has the highest valuation).
\textsuperscript{269} See \textit{supra} notes 156-157, 167-169, and accompanying text.
\textsuperscript{270} See \textit{supra} note 245 and accompanying text.
\textsuperscript{271} This may explain, in part, Hambrecht’s decision not to publish its pro rata allocation data. See \textit{supra} note 181.
\textsuperscript{272} See \textit{supra} notes 194-196 and accompanying text.
B. Bidding Rings

A simpler and superior scheme would be to form a bidding ring.273 In essence, by agreeing not to compete with each other, prospective investors can assume joint control over the auction price.274 While a variety of forms exist,275 all successful bidding rings must satisfy at least four conditions. First, the ring members must agree on how to allocate profits.276 Second, that agreement must be self-enforcing.277 Third, there must be barriers to new bidders.278 And, fourth, a bidding ring must be sufficiently stable to withstand attacks from victims.279

Notably, none of these conditions requires that all buyers participate in the bidding ring. Intuitively the ideal bidding ring might include all buyers, who in turn can select a representative to act as a monopsonist with the seller.280 But a bidding ring can operate in a dual market, split

---

273 McAfee and McMillan note:
Bidding conspiracies are prevalent enough to have added some exotic locutions to the English language. Cartels are variously called “rings,” “pies,” and “kippers.” A “schlepper” is an insincere bidder attracted solely by the cartel’s profits, and a “shill” is a phony bidder used by the auctioneer to drive up the price. A “knockout” is a private auction held by the cartel to determine which member gets the item and how much he pays the other members.

McAfee & McMillan, supra note 243, at 579, 579 n.1.

274 See, e.g., CASSADY, supra note 30, at 177 (“When all the buyers who are interested in the same merchandise are included in the [bidding] ring, buyer competition gives way to monopsony, or buyer monopoly.”).

275 See, e.g., id. at 177-92 (delineating different types of bidding rings in the antique, fish, and wool industries).

276 See, e.g., McAfee & McMillan, supra note 243, at 583-88 (observing this is an adverse selection problem, as colluding bidders “do not know how much of their fellow cartel members is willing to pay for the item being sold”); see also generally Akerlof, supra note 73 (seminally delineating adverse selection problem).

277 See, e.g., Dilip Abreu et al., Optimal Cartel Equilibria with Imperfect Monitoring, 31 J. ECON. THEORY 351 (1986).


279 See, e.g., Marc S. Robinson, Collusion and the Choice of Auction, 16 RAND J. ECON. 141, 143 (1985) (“For the prospective cartel to be stable, the recommended cartel strategies should be incentive-compatible, at least in the weak sense that some other strategy for an individual bidder not be strictly preferred by that bidder, given what the others are doing.”) (emphasis in original). Incentive-compatibility is a function of sharing information, which is crucial for any bidding ring’s stability. See, e.g., id. at 141 & n.1 (“[A]s long as all cartel members share the same information, cartels are stable (i.e., incentive-compatible) . . . . What is crucial for the results is . . . whether the cartel members regret their strategies if cheating occurs.”). Sealed-bid auctions, however, tend to be less susceptible than their oral counterparts to bidding rings. See, e.g., Walter J. Mead, Natural Resource Disposal Policy-Oral Auction vs. Sealed Bids, 7 NAT’L RES. J. 194, 223 (1967) (concluding that “[o]ral bidding is vulnerable to collusive practices among bidders as well as to certain devices of unfair competition and emotionalism” to a greater degree than sealed bidding).

280 See, e.g., CASSADY, supra note 30, at 178 (“An attempt is made to identify and make arrangements with all buyers who are expected to be interested in a particular item or a lot of goods. Once this task is accomplished, one buyer, acting for all, is in a
between ring and non-ring buyers.281 Indeed, such a dual market can be preferable:

An obvious absence of competition would almost certainly alert the seller or his agent and lead to defensive action against the ring . . . . In fact, the appearance of competition is so important that the head of the [bidding ring] may find it necessary, in the absence of actual competition, to provide simulated competitive activity by assigning bidding roles to certain ring members, who stop either at a pre-arranged cutoff point or at a signal from the leader.282

This simulated competition, or phantom bid, strategy is possible because ring buyers do not participate in an auction as individuals, but as a group.283 Any proceeds from the auction belong to the bidding ring, and are shared among its members instead of the individual member with the winning bid.284 A bidding ring thus seeks to maximize its joint expected profits.

Such profits typically are determined and then distributed through separate auctions. Prior to the at-large auction, the bidding ring ascertains each member’s valuation through bids.285 The member with the highest valuation then submits a bid for the ring in the at-large auction.286 Should the bidding ring prevail, it will conduct another auction, or a “knockout.”287 Every member of the bidding ring then position to exert complete monopsonistic power and thus depress prices drastically . . . .”); Graham & Marshall, supra note 275, at 1220 (“The ring appoints a sole bidder who bids on behalf of the coalition at the auction.”).

281 See, e.g., CASSADY, supra note 30, at 178 (“There would be a dual market situation: one market would include all the interested buyers, uniformed as well as informed, and the other would include only those who are informed. It is the informed segment that the ring leader attempts to control . . . .”). See also Graham & Marshall, supra note 275, at 1221 (“[I]f two or more distinct [collusive] coalitions appear at the same auction, they will invariably merge to form a single coalition.”).

282 CASSADY, supra note 30, at 179.

283 See, e.g., Kenneth Hendricks & Robert H. Porter, Collusion in Auctions, 15/16 ANNÆLES D’ÉCONOMIE ET DE STATISTIQUE 217, 221 (1989) (“[Phantom] bids may be submitted to create the appearance of competition. . . . [G]iven the available data, it would be very difficult to detect the presence of an inclusive cartel that submitted phantom bids.”).

284 See, e.g., Graham & Marshall, supra note 275, at 1220 (“The benefits of ring formation are shared among members rather than, for example, accruing entirely to the ring member who ultimately obtains possession of the item.”).

285 This valuation need not even be accurate for the bidding ring to work successfully. See, e.g., McAfee & McMillan, supra note 243, at 580 (“The revelation principle states that the outcome of any mechanism [for assigning bids and post-auction transfers] that is not incentive-compatible can be mimicked by one that is incentive-compatible, so that honesty can be assumed without loss of generality.”).

286 See, e.g., id. at 586 (“An optimal cartel mechanism has the property that the bidder with the highest value if and only if his value exceeds r and the seller receives r.”).

287 Not all bidding rings, however, are capable of making post-auction transfer payments. As McAfee and McMillan have demonstrated, “weak” bidding rings operate by submitting identical bids that effectively convert the auction process into a random contest among the colluders. See id. at 584 (“Why do the bidding firms choose such an apparently naïve form of coordination? The answer . . . is that, given the asymmetry of
receives a portion of the difference between the winning bids in the at-large and knockout auctions.  

Though there is no honor among thieves, bidding rings tend to be rather effective at self-enforcement. When there is only one auction, the bidding ring clearly will not have resort to threat of future retaliation, but instead may have to implement what has been called “an organized-crime approach” to punishment. When there are repeated auctions or interaction among the bidding ring members, the threat of future retaliation is usually sufficient to secure cooperation. And case studies of retaliation in various industries ironically demonstrate that “it works very much to the seller’s advantage as vindictive competition leads to crazy prices.”

On the flip side legal prophylactics tend to be not only scarce, but ineffective. One of the few such examples is England’s Auctions (Bidding Agreements) Act of 1927, which prohibits any agreements to abstain from auctions:

If any dealer agrees to give, or gives, or offers any gift or consideration to any other person as an inducement or reward for abstaining, or for having abstained, from bidding at a sale by auction either generally or for any particular lot, or if any person agrees to accept, or accepts, or attempts to obtain from any dealer any such gift or consideration as aforesaid, he shall be guilty of an offense under this Act.

This statute, however, “is seldom invoked, and has had almost no effect on ring operations in England.” Perhaps the closest American analogue to the Bidding Agreements Act is the Sherman Act, but its prohibitions are tailored to cartel arrangements that are analytically

---

288 See, e.g., id. at 587-88. Even distributions of the difference, however, may not be optimal. See, e.g., Robinson, supra note 279, at 144 (contending that even payment of ex post profits would fail to establish a Nash equilibrium in a sealed-bid auction among otherwise compliant ring members).

289 McAfee & McMillan, supra note 243, at 581.

290 See, e.g., id. at 581 (“A deviating bidder can be threatened with noncooperative profit levels in all future auctions should he win the current auction when the mechanism dictated otherwise. This threat will be sufficient to deter deviations if discounting is sufficiently low.”).


292 2(3) HALSBURY’S LAWS OF ENGLAND § 246, at 120 (Lord MacKay, 4th ed. 2003). The penalty for such an offense is either a fine capped at the prescribed sum, six month imprisonment, or both. Id. at 120 n.7.

293 CASSADY, supra note 30, at 191; see also id. (concluding in passing that “recourse to law is at best a doubtful way of stamping out ring activities”).

distinct from auction-related collusion. The law thus affords sellers extremely limited formal means for detecting and combating bidding rings.

Sellers, however, are hardly helpless victims of bidding rings. They have recourse to private countermeasures that involve lower transaction costs than formal legal means. In the short run a seller simply can retract its item or select a bid from a friendly party. In the long run a seller can protect itself by submitting its own phantom bids or using an arbitrary or unpredictable method to selecting winning bidders. A seller also can set a reserve price, thereby diminishing the bidding ring’s profit margin; that reserve price then can be adjusted upwards or downwards to influence the expected purchase price. And a seller could withhold certain bidding information, such as the winning valuation, in an attempt to disrupt the bidding ring’s ability to divide spoils or detect cheating internally.

While scarce, some evidence of bidding rings does exist. Priceline.com, for instance, features a patented online Dutch auction.

---

295 See, e.g., Robert C. Marshall & Michael J. Meurer, Bidder Collusion and Antitrust Law: Refining the Analysis of Price Fixing to Account for the Special Features of Auction Markets, 72 ANTITRUST L.J. 83, 83 (2004) (“[T]here are significant differences regarding the economics of collusion in auction and procurement markets as compared to posted-price markets . . . .”). Antitrust actions may be relevant, however, in that they are notoriously costly and difficult to conduct, much less win. See, e.g., John E. Lopatka & William H. Page, Economic Authority and the Limits of Expertise in Antitrust Cases, 90 CORNELL L. REV. 617, 639 (2005) (referencing the “daunting evidentiary challenges in antitrust litigation” and general skepticism that even the “‘big case’ is worth its institutional costs”) (citations omitted).

296 Indeed, this may be the primary reason why legal regulation of auctions is so scarce.

297 See, e.g., CASSADY, supra note 30, at 191 (“Upon recognizing the existence of a ring, the auctioneer not only can disregard the bids of the ring leader, but can actually make a sale to a friendly buyer. . . . Perhaps the most effective defensive tactic is to run up the price of an article by the use of phantom bids, or bids from nonexistent traders.”). But see, e.g., Klemperer, supra note 278, at 176 (“It may not be credible for the auctioneer to punish a bidder violating the auction rules when just one bidder needs to be eliminated to end an auction, because excluding the offending bidder would end the auction immediately, and it might be hard to impose fines large enough to have a serious deterrent effect.”).

298 See, e.g., Hendricks & Porter, supra note 283, at 221 (“The oligopoly literature suggests that increasing this sort of uncertainty can be fatal to a collusive agreement.”). In the case of identical bids the seller could select the winning bid on a mercurial arbitrary basis.

299 See, e.g., CASSADY, supra note 30, at 191 (“In some auctions, the most effective way of overcoming a buyer’s ring is to set a reserve price, prohibiting sale of the item below its estimated value and thus impairing the profitability of a collusive operation.”).

300 See supra note 288.

301 See, e.g., Hendricks & Porter, supra note 283, at 223 (“Clearly, restricting information flows within the cartel may hinder its ability to detect cheating.”).

302 See, e.g., Thel, supra note 261, at 280-81 (“Aside from being diverse and transitory, the details of common manipulative techniques are hard to discover. The success of many manipulative schemes often depends upon the target’s ignorance . . . . [T]hus, manipulative practices are likely to be disguised, and accordingly, they are hard to study.”).
process for travel-related services. Bidders name the maximum price and quantity they are willing to purchase, and the company’s engine matches these sealed-bids to the available supply. This process, however, has spawned an elementary bidding ring. A website, Bidding For Travel.com, has the primary goal of “promoting informed bidding when using [P]riceline.com’s (US) travel products.” Individuals post information that includes failed and winning bids, re-bidding strategies, and anecdotal evidence about the auction engine’s mechanics. While the forum does prohibit bidders from attempting to re-sell winning bids, contacting each other or even setting up an alternative place to conduct a knockout auction is hardly formidable.

In the same way prospective investors could establish an elementary Dutch IPO bidding ring. A website or accessible forum would enable prospective investors to meet and exchange information. That mechanism would collect and disseminate data on the number of parties interested in submitting bids as well as their preferred allotment and valuation of IPO shares. This data in turn would facilitate the ability of all ring members to estimate market demand and execute a reduced allocation strategy. And, as the members would simply be exchanging data, and not coordinating bids, such an elementary ring would not require an agreement. Detecting such a tacit strategy thus would be extremely difficult.

303 But see Eugene R. Quinn, Jr., Abusing Intellectual Property Rights in Cyberspace: Patent Misuse Revisited, 28 WM. MITCHELL L. REV. 955, 956-57 (2002) (noting that “[t]his patent purports to give Priceline.com the exclusive right to what is known as a Dutch auction, something that is hardly new or unobvious. . . . Apparently, the fact that a Dutch auction has never been done online makes this particular business method patentable.”).


305 Id.


307 See Requests to Re-Sell Are Off Topic and Will Be Removed, http://p070.ezboard.com/fpricelineandexpediabiddingpostingguidelines.showMessage?topicID=23.topic (last visited Jan. 2, 2007) (“Effective immediately, it is the policy of BiddingForTravel.com that the posting of any future requests to re-sell a winning bid are off topic and any such requests will be removed.”).

308 Google and all OpenIPOs have used sealed-bids.

309 See supra notes 259-261 and accompanying text.

310 More sophisticated rings might prefer an agreement or some kind of arrangement to ensure that the members supply reliable bid information.

311 To be sure, an agreement would enhance the ring’s ability to enforce itself, and thus be stable. Cf. supra notes 289-290 and accompanying text. But a simple and noncommittal arrangement stands a better chance of attracting a larger pool of institutional and retail investors, and thus more complete market demand information.
A more sophisticated ring might involve coordinated collusion strategies. Prospective investors could agree to submit multiple bids, either individually or as a group, that comprise a spread of different allocations and prices. Some of these bids could be of the phantom sort, designed to mask the ring’s true preferences. And other bids could be of the insincere sort, designed to manipulate the demand curve into underpricing the issue.

The problem is magnified by the Dutch IPOs profit function. Provided the expected short-run or long-run return exceeds a prospective investor’s IPO valuation, there is an incentive to participate in a bidding ring. On the one hand, in the short-run, a ring member can benefit from either a simple discrepancy in valuation or an anticipated first-day pop; these incentives arguably applies most strongly to retain investors, who are likely to infrequent bidders that can afford not to act in a risk-averse or reputation-preserving manner. On the other hand, in the long-run, a ring member can benefit from future business with other members, either another IPO ring or some other unrelated venture; these arrangements arguably favor institutional investors, who enjoy a superior network and position to organize and distribute a knockout auction.

Moreover, such tactics are hardly the exclusive province of investors. As a preliminary matter, bidding rings and their manipulative strategies are equally available to issuers. There is no reason why an issuer could not submit actual or phantom bids to buoy the offering price. Indeed, issuers may be well-positioned to execute such a strategy by virtue of their access to the market demand data. In this regard Dutch IPOs present a peculiar and real risk of fraudulent issuers manufacturing their own demand and thus directly manipulating their own equity. And by cutting out underwriters, Dutch IPOs effectively grant issuers access to the investing public that is unmediated by any independent private gatekeepers.

Instead that gatekeeping function belongs to the issuer’s Dutch IPO platform. Hambrecht’s website, for instance, provides the following disclaimer:

WRH+Co reserves the right to reject bids that it deems manipulative or disruptive in order to facilitate the orderly completion of an offering, and it reserves the right, in exceptional circumstances, to alter the method of allocation as it deems necessary to ensure a fair and

---

312 See supra notes 281-283 and accompanying text. Issuers also can submit “shill” bids, in which either they or their associates attempt to drive up the price and generate market demand.

313 This manipulation is not restricted to lowering the clearing price. Affluent repeat investors could benefit from a higher clearing price, which might diminish market demand and thus allow only purchasers of significant blocks of shares to capitalize on pricing spreads. Moreover, highly sophisticated investors might attempt to manipulate the demand curve to glean more information about the issuer’s allocation formula and private self-valuation.

314 Bidding rings featuring short-term or one-time investors, however, have a limited capacity for self-enforcement and stability.
orderly distribution of the issuing company’s shares. . . .

In addition, WRH+Co may reject or reduce a bid by a prospective investor who has engaged in practices that could have a manipulative, disruptive or otherwise adverse effect on an offering.315  

to date there are no reported instances of Hambrecht having exercised this right. Nevertheless, beyond its apparent deterrent value, this classic countermeasure,316 combined with an opaque pricing formula,317 does represent an effective way to combat a bidding ring.

Unfortunately, the countermeasure cannot compensate entirely for deficiencies that inhere within the Dutch IPO method. For the offering price to reflect market demand fully, and thus eliminate underpricing, the bidding pool perforce should include all investors. This influx of unsophisticated retail bids opens the door to a dual market that disguises the presence of bidding rings.318  Ring members thus enjoy not only the cover of non-members, but also of unsophisticated investors, a problem that merely increases with the size of the IPO. As a result, ring members and sophisticated investors are ironically the most likely beneficiaries of democratic access.

Further, Dutch IPOs require a significant degree of transparency. This is because pricing and allocation are predicated on actual bids. Although the bids are sealed during the auction phase, the distribution of prices and quantities requested by the entire prospective investor pool as well as the pro rata allocation data are arguably material information for aftermarket purchasers.319  Such information, however, epitomizes the dilemma posed by Dutch IPOs. On the one hand increased disclosure will better equip manipulative and strategic bidders. On the other hand such disclosure may be necessary to guard against fraudulent Dutch issuers.320

In sum Dutch IPOs introduce a unique set of manipulative and fraudulent tactics. Both the reduced allocation strategy and bidding rings are premised on features specific to auctions. These tactics, however, are largely inapplicable to the bookbuilding method. The relationship between underwriters and preferred investors rests on effective bonding

315 See W.R. Hambrecht + Co., OpenIPO: Frequently Asked Questions, http://www.wrhambrecht.com/ind/auctions/openipo/faq.html (last visited Jan. 2, 2007); see also id. ("[L]arge orders may be reduced to ensure a public distribution, and bids may be rejected or reduced based on eligibility or creditworthiness criteria.").
316 See supra notes 297-298 and accompanying text.
317 See supra notes 171-173 and accompanying text.
318 See supra notes 281-282 and accompanying text.
319 Indeed, such information is available for many foreign auction-based IPOs. See, e.g., Biais et al., supra note 224, at 117 (France); Jagannathan & Sherman, supra note 141, at 62 fig. 2 tbl. 1 (Singapore).
320 One way to resolve this tension might be to increase the involvement of the NASD, NYSE, or SEC. In fact various other countries charge a centralized governmental body with operating and overseeing the entire Dutch IPO process. This, however, is assuredly a costly process that would further strain already limited governmental monitoring and enforcement resources. And such a commitment is hardly warranted until, or unless, Dutch IPOs become far more prevalent here than the present.
and reputational mechanisms. To be sure, the bookbuilding method is not immune from manipulation or fraud. But Dutch IPOs introduce a different set of potential problems that should be considered within any comparative assessment of methods.

CONCLUSION

The movement for Dutch IPOs is a coalition of two groups. Some support this alternative method out of dissatisfaction with abusive allocation practices and astronomical underpricing levels during the internet bubble period. Others support the method for its promises of a more efficient, egalitarian, and equitable offering process.

Neither group, however, presents a convincing case. Critics of bookbuilding have rushed to broad conclusions inferred from anecdotal and incomplete data that fail to engage extensive financial literature justifying underpricing and certain preferential allocation practices. Further, the data on Dutch IPOs present, at best, a mixed picture in comparison to their bookbuilt peers. And whether English or Dutch, auction-based IPOs are uniquely vulnerable to certain manipulative practices and bidding rings.

The soundest conclusion for now is that we have not advanced beyond the findings of the blue-ribbon committee commissioned by the SEC. Specifically, the committee concluded that “[t]he market, and not regulators, should determine whether a Dutch auction or another method is desirable for a particular IPO.”321 At present, the available empirical and theoretical evidence supplies no reason for Dutch IPOs to displace bookbuilding.

At the same time Dutch IPOs do represent a functional option. Any appraisal of this alternate method, however, should consider comprehensive data, interpret those results carefully, and utilize sound inferences. When one considers the substantial stakes issuers, investors, and underwriters have in the public offering process, demanding concrete proof about an alternative method seems not only reasonable, but appropriate.

321 IPO COMM., REPORT, supra note 11, at 9.