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## **The Puzzling Persistence of the Fixed Price Offering:**

### **Implicit Price Discrimination in IPOs**

Sean J. Griffith\*

#### ABSTRACT

This chapter for a book on the regulation of primary securities markets investigates the persistence of the fixed price offering in the United States. Fixed price offerings present a puzzle because economic theory suggests that sellers would maximize returns by offering IPO shares for sale at different prices depending upon characteristics of the buyer or the buyer's order. Contrary to this expectation, however, American companies uniformly sell IPO shares at a single fixed offering price. Moreover, this is true regardless of whether the shares are sold through the traditional book-building process or at auction. This phenomenon is not a function of the legal or regulatory structure governing public offerings in the United States, which neither mandates fixed price offerings nor bars price discrimination in IPOs. Instead, it appears to be a result of the market power of underwriters. A close examination of the offering process reveals a form of *implicit* price discrimination in which underwriters clearly engage—that is, the selective allocation of shares with resale restrictions. The chapter argues that underwriters favor implicit price discrimination over explicit price discrimination because the benefits of implicit price discrimination redound to the underwriter while explicit price discrimination would benefit issuers and eliminate an important (but hidden) component of underwriter compensation.

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## **Introduction**

It is common to celebrate the breadth and liquidity of U.S. capital markets. For example, in a speech at the London School of Economics, William Donaldson, former Chairman of the U.S. Securities and Exchange Commission, noted that half of all the world's equity trades in the United States and that non-U.S. investors have approximately \$4.5 trillion under investment in U.S. stock markets.<sup>1</sup> Nevertheless, many aspects of these markets are poorly understood. The IPO market, in particular, is a rich source of mystery.<sup>2</sup> Why, for example, are IPO shares frequently offered at a large discount from the price at which they will immediately trade in the secondary market?<sup>3</sup> And why do investors continue to subscribe to IPOs in spite of the fact that IPO shares appear to perform worse than the shares of comparable companies over the long term?<sup>4</sup>

A puzzle that is less often remarked upon is the fact that companies go public at a single offering price instead of several. American companies uniformly sell IPO shares at a single fixed offering price rather than at different prices depending, for example, on the number of shares purchased or the identity of the purchaser. Moreover, this is true regardless of whether the shares are sold through the traditional book-building process or through an auction. Google, for instance, sold its IPO shares at \$85 regardless of whether the buyer was an individual or an institution, or a purchaser of 100 or 100,000 shares.

The persistence of the fixed price offering is a puzzle because economic theory posits that sellers may often maximize returns by offering the same commodity for sale at different prices depending upon characteristics of the buyer or the buyer's order. As described in greater detail below, this is the practice of price discrimination, and it enables the producer to capture consumers' surplus—that is, the marginal gains reaped by consumers when they are able to purchase a commodity at less than their reservation value. Yet price discrimination does not seem to occur in IPOs because all shares are sold at a single, fixed price. Why would this be if issuers, like other producers, can maximize returns through price discrimination?

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<sup>1</sup> William H. Donaldson, "U.S. Capital Markets in the Post-Sarbanes-Oxley World: Why Our Markets Should Matter to Foreign Issuers," London, England (Jan. 25, 2005), available online at <http://www.sec.gov/news/speech/spch012505whd.htm>.

<sup>2</sup> An initial public offering ("IPO") is a company's first broad distribution of equity securities. Although the corporation may previously have sold stock in relatively small private placements of securities, the IPO signals the entry of a firm into the broader public market.

<sup>3</sup> See, e.g., Jay R. Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. Fin. 1795 (2002).

<sup>4</sup> See Louis Lowenstein, *Shareholder Voting Rights: A Response to SEC Rule 19c-4 and to Professor Gilson*, 89 COLUM. L. REV. 979, 998 (1989) ("New issues are overpriced and underpriced all at the same time, but it is the overpricing that determines the ultimate outcome."); Jay R. Ritter, *The Long-Run Performance of Initial Public Offerings*, 46 J. FIN. 3 (1991) (finding that IPOs significantly underperform comparable firms over a 3 year period and summarizing studies finding negative long-run IPO performance). *But see* Paul A. Gompers & Josh Lerner, *The Really Long-Run Performance of Initial Public Offerings: The Pre-Nasdaq Evidence*, 58 J. FIN. 1355 (2003) (demonstrating, over a large sample of firm-commitment IPOs in the United States from 1935-1972, that overall performance depends upon how returns are measured and that under some methods underperformance disappears altogether).

IPO researchers often assume that fixed price offerings are required by law.<sup>5</sup> This assumption, however, is incorrect. As will be described below, the legal and regulatory structure governing public offerings in the United States neither mandates fixed price offerings nor bars price discrimination in IPOs. Given the potential value of price discrimination to issuers and the lack of a legal prohibition against it, what explains the persistence of the single, fixed offering price?

This chapter explores the puzzle of the fixed price offering. It begins by explaining price discrimination and consumers' surplus, then describing how price discrimination could be used to maximize offering proceeds. The chapter then contrasts this theoretical model with the actual operation of public offerings in the United States and analyzes the legal and regulatory structure governing IPO pricing. Next, the chapter argues that in spite of the fact that IPO shares are sold at a single fixed price, a form of implicit price discrimination may take place through the selective inclusion of resale restrictions and the preferential allocation of underpriced shares. The chapter ultimately explains the presence of implicit price discrimination and absence of explicit price discrimination by reference to differences in bargaining power between the underwriter and the issuer.

## **I. Price Discrimination**

Imagine an investor facing the decision of whether or not to buy shares in an IPO. The company that is going public has a wide analyst following and is expected to perform well as soon as it begins trading. Assume that after taking all of this into account, the investor would be willing to pay up to \$50 per share to buy the company's stock. Now assume the company goes public at \$30 per share. The investor, it seems, has received a bargain, paying \$20 less per share than he or she would have been willing to pay. The effective savings of \$20 per share is the consumers' surplus in the offering.<sup>6</sup>

IPO underpricing may be a form of consumers' surplus. The average "underpricing discount" in U.S. offerings has hovered around 19%, but underpricing margins fluctuate widely in different markets. In the 1960s, underpricing averaged 21%, then fell to 12% in the 1970s, rising to 16% in the 1980s, then to 21% in the 1990s, finally jumping to 40% in the four years since 2000.<sup>7</sup> This consistent disparity between the price at which shares are sold in the IPO and the market price at which they

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<sup>5</sup> Alexander Ljungqvist and William Wilhelm, for example, two of the most prominent financial economists working in the area, recently wrote "Explicit price discrimination in the sale of IPOs is prohibited in the U.S. as well as in most other jurisdictions." Alexander P. Ljungqvist & William J. Wilhelm, Jr., *IPO Allocations: Discriminatory or Discretionary?*, 65 J. FIN. ECON. 167 (2002). As this chapter shall explain, this statement, made without a supporting reference, is incorrect.

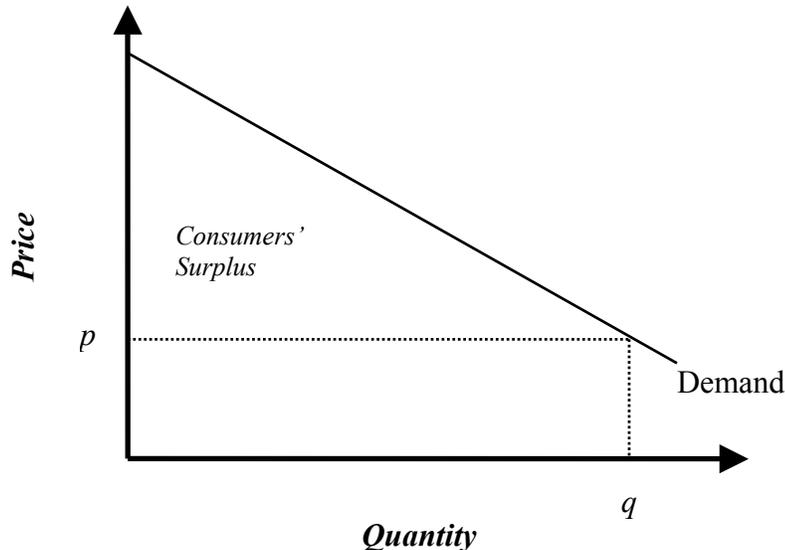
<sup>6</sup> See PAUL A. SAMUELSON & WILLIAM D. NORDHAUS, *ECONOMICS* 96-98 (17<sup>th</sup> ed. 2001) (describing consumers' surplus). The application of consumers' surplus to securities assumes a downward sloping demand curve for securities which, as described in the text, is controversial.

<sup>7</sup> See Alexander Ljungqvist, *IPO Underpricing*, in *HANDBOOK IN FINANCE: EMPIRICAL CORPORATE FINANCE*, B. ESPEN ECKBO, ED., ch. III.4. (Sept. 1, 2004).

subsequently trade seems to represent a bargain for the IPO investor and, equally, a foregone opportunity for the issuer.<sup>8</sup>

Any time buyers on the whole place a total value on some commodity that is greater than the amount they are forced to pay to purchase the commodity, the result, as represented in figure 1, is consumers' surplus.

**Figure 1. Consumers' Surplus**



Because a single price cannot reflect the value that all buyers place on a good, fixed price sales commonly result in consumers' surplus.

There is some controversy in applying the concept of consumers' surplus to securities markets since, under some theories of securities pricing, demand curves are presumed to be flat.<sup>9</sup> Because sophisticated investors with large amounts of capital dominate securities markets, stock prices tend to reflect their estimates of value, which are based on the risk-and-return blend offered by the security. Accordingly, if these sophisticated investors believe a security is overpriced given the blend of risk and return it offers, they will not buy a single share, but will instead substitute an appropriately priced security providing the same blend of risk and return. Similarly, they will continue to buy underpriced securities until the price appropriately reflects the risk-return blend. According to this account, the demand curve for stocks thus is flat and matches the

<sup>8</sup> Economists have referred to underpricing margins as “money left on the table.” See, e.g., Tim Loughran & Jay R. Ritter, *Why Don't Issuers Get Upset About Leaving Money on the Table in IPOs?*, 15 REV. FIN. STUD. 413 (2002).

<sup>9</sup> See RICHARD A. BREALEY & STEWART C. MYERS, *PRINCIPLES OF CORPORATE FINANCE* 375 (6<sup>th</sup> ed. 2000) (arguing that because stocks are perfectly substitutable, or nearly so, the demand curve for a given security is horizontal).

market price. Above the line, no securities will be sold, below the line, a theoretically infinite number of sales will occur.

The hypothesis that stocks have a flat demand curve is currently a contested one in finance.<sup>10</sup> If a significant number of investors do not think of shares of similar firms as perfect substitutes, then the price of a firm's securities may reflect the ungrounded estimates of optimists and pessimists.<sup>11</sup> The flat demand hypothesis is particularly suspect in hot markets for new issues, where investors seem to play favorites for reasons other than risk and return. A new issue may have little or no earnings history and a very short record of the kind of accounting measures that enable investors to estimate the risk-return blend. With a paucity of reliable information, the professionals' estimates may come to resemble the amateurs' more intuitive appraisals. Furthermore, even if professionals do suspect that amateurs' sentiments have inflated the value of IPO securities, they may be unable to correct the mispricing through arbitrage due to the inability to find shares to sell short.<sup>12</sup> As a result, if securities ever do have a downward sloping demand curve, it would seem that IPO stocks are the most likely candidates, leading to the creation of consumers' surplus in the new issues market.

Sellers can capture consumer surplus by engaging in price discrimination. When different buyers would pay different prices for the same commodity or when the same buyer would pay different prices for various amounts of the same commodity, the seller can maximize returns by selling the commodity at different prices depending upon either the identity of the buyer or the quantity purchased. The seller's total return is greater under price discrimination than it would be under a single fixed price because, as represented in figure 2, there is less total margin between price and demand.

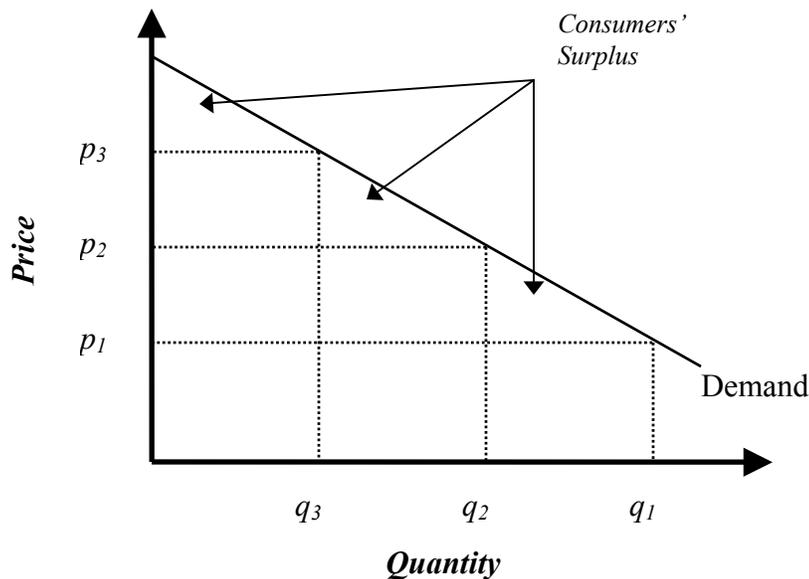
### **Figure 2. Price Discrimination**

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<sup>10</sup> Aditya Kaul *et al.*, *Demand Curves for Stock Do Slope Downward: New Evidence from Index Weights Adjustment*, 55 J. FIN. 893, 911 (2000) (showing that a change in the weights given of stocks on an index of the Toronto Stock Exchange resulted in price changes in spite of the fact that the change in weights conveyed no new financial information concerning the securities and interpreting this evidence as support for the hypothesis that demand curves for stocks slope downward). Accord Laurie Simon Bagwell, *Dutch Auction Repurchases: An Analysis of Shareholder Heterogeneity*, 47 J. FIN. 71 (1992); Andrei Shleifer, *Do Demand Curves for Stocks Slope Down?*, 41 J. FIN. 579 (1986).

<sup>11</sup> See generally Lynn A. Stout, *How Efficient Markets Undervalue Stocks: CAPM and ECMH Under Conditions of Uncertainty and Disagreement*, 19 CARDOZO L. REV. 475, 484-91 (1997).

<sup>12</sup> See, e.g., Christopher C. Geczy, *et al.*, *Stocks are Special Too: An Analysis of the Equity Lending Market*, 66 J. FIN. ECON. 241 (2002) (showing that borrowing IPO stock for short selling in the early aftermarket is difficult and extremely costly); Todd Houge, *et al.*, *Divergence of Opinion in IPOs*, 30 FIN. MGMT. 5 (2001) (discussing the difficulty of short selling in the early aftermarket).



Two features are necessary for successful price discrimination.<sup>13</sup> First, in order to charge different buyers different prices, sellers must be able to distinguish between them, keeping track of the value different buyers place on the commodity. Second, in order to charge different prices for different amounts purchased, the seller must be able to prevent resale transactions where low-price buyers sell to high-price buyers, thus eliminating through arbitrage the ability of the seller to charge different prices for different order sizes.

Each of these features is present in the IPO market. First, sellers can differentiate among buyers when they take orders. Regardless of whether the offering is made in the form of an auction or a more traditional book building exercise, the party taking the order can learn the identity of the prospective purchaser, determining for example, whether the buyer is an individual or an institution, a new entrant into the market or a repeat player, and so on. Second, when selling to the buyer, the seller can force the buyer to agree to restrictions on its ability to resell the securities, thereby preventing the buyer from engaging in the forms of arbitrage that would undo the ability of the seller to engage in price discrimination. Resale restrictions that prevent buyers from selling for a specified period after the IPO, so-called “anti-flipping restrictions,” are in fact a common aspect of IPO allocations.<sup>14</sup>

Price discrimination could thus be accomplished in IPOs. In taking orders, the seller could sell to high volume buyers (institutional investors) at one set of prices and to low volume buyers (individuals) at another. Because of their greater bargaining power,

<sup>13</sup> See SAMUELSON & NORDHAUS, *supra* note 6, at 190-91 (describing price discrimination and providing examples).

<sup>14</sup> See *infra* notes 57-59 and accompanying text (describing the ability of underwriters to make allocations burdened by resale restrictions).

the price paid by institutions would likely be lower than the price paid by individuals. Nevertheless, this discount should be recouped through the premiums individuals have been willing to pay for an IPO allocation. In this way, sellers could capture the consumers' surplus currently enjoyed by those individual investors lucky enough to receive an IPO allocation.

Taking consumers' surplus from individual investors may seem to raise distributive concerns. Is it fair to take the marginal gains enjoyed by individual consumers and redistribute them to the seller? In the IPO context, however, these distributional consequences are much less problematic than in ordinary consumer contexts. First, a central goal of the offering system is to promote efficiency by enabling corporations to maximize the amount of capital they can raise in public offerings. Price discrimination would thus improve primary market efficiency by increasing the benefits of the offering to sellers. Second, insofar as this benefit comes at the expense of smaller individual investors, a class most policy-makers are concerned with protecting, it should also be remembered that most investors, especially low net worth individuals, participate in securities markets generally and IPOs in particular through institutional investment funds and not, in fact, as individual investors. Institutional investors are no worse off and may in fact be better off by a system that engages in price discrimination. As a result, individuals are in fact indirect beneficiaries of price discrimination and thus share in the benefits of any mechanism that improves the efficiency of the primary markets.

In spite of these benefits, U.S. companies do not in fact engage in price discrimination when they sell their shares into the public markets. Why not?

## **II. The Public Offering**

The reality of the public offering in the United States does not match the theory of price discrimination. Before we can understand why, we must understand how the offering process works. This section reviews the mechanics of the offering process, discusses the legal and regulatory structure that undergirds that process, and seeks to put the system into historical context.

### *A. The Offering Process*

Public offerings of securities in the United States involve several players with distinct roles. First, there is the "issuer," the company whose securities will be sold. Next, there is the investment bank that agrees to sell the securities for the issuer, referred to as the "underwriter." In a small offering, the underwriter may sell directly to investors, or as is more common in large offerings, the underwriter may act as a wholesaler, placing the offering with a group of retailers who sell to the investing public. The ultimate distributors may thus be either "dealers," if they purchase shares to resell to the public or "brokers" if they merely serve as transaction intermediaries.

In a firm commitment underwriting, the form of securities offering insisted upon by reputable issuers, the underwriter puts its own capital at risk by first purchasing the issuer's securities and then reselling them.<sup>15</sup> The investment banking firm originally retained by the issuer serves as the lead or managing underwriter and conducts all subsequent negotiations with the issuer, including the ultimate pricing of the issue. In order to spread the risk of the firm commitment underwriting, however, the lead underwriter will typically seek to involve other investment banks in the offering. This is the process of syndication.

The managing underwriter invites other banking houses to share the risk and rewards of the offering, and those that join enter into the "underwriting agreement" with the issuer, in which each commits to purchase a stated number of shares from the issuer.<sup>16</sup> The members of the underwriting syndicate then organize the "road show" for the offering, a series of meetings and presentations to promote the offering to brokers and large investors.<sup>17</sup> The issuer's managers speak at these presentations, and afterwards the bankers take "indications of interest" from prospective investors—conditional offers to buy a stated amount of shares at a stated price—using these indications of interest to gauge demand and ultimately price the offering.<sup>18</sup>

Among themselves, the members of the underwriting syndicate also enter into an "agreement among underwriters." The agreement among underwriters establishes each syndicate member's proportionate liability, usually tied to the member's percentage participation in the offering, and appoints the managing underwriter as syndicate manager. Each syndicate member is given control over a limited allotment, known as the member's "retention," with the rest of the offering, the "pot," under the discretionary

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<sup>15</sup> In this way, firm commitment underwritings allocate market risk to the underwriter. As a holder of the issuer's securities, the underwriter bears the risk that the shares will not sell quickly, or worse, that they will not sell at all. If the shares cannot be sold, the underwriter bears the losses. Moreover, if the shares do sell, but slowly, the underwriter will suffer losses as its cost of capital and opportunity costs increase. As a prominent underwriter once explained:

[I]f underwriting firms simply took up the securities committed for under their underwriting contract and then were unable to resell them to the investing public, it would not take long for underwriting capital to be fairly locked up in unsold commitments. The consequent effect on markets could and, no doubt, would be disturbing; since until undigested issues held by underwriters could be liquidated new transactions could not be properly underwritten, and the whole new-issue machinery supplied by investment bankers would be definitely stalled.

Percy M. Stewart, *Syndicating*, in JOHN F. FENNELLY, *et al.*, FUNDAMENTALS OF INVESTMENT BANKING, at 95 (Chicago: Investment Bankers Association of America 1947).

<sup>16</sup> The underwriting agreement also contains representations and warranties of the issuer, promising among other things, that the offering documents contain no untrue statement of material fact and that no material adverse event with respect to the issuer's business has occurred. The underwriting agreement typically also contains a clause requiring the issuer to indemnify the underwriters for any state or federal liabilities incurred as a result of materially misleading statements in the offering documents.

<sup>17</sup> See Ed McCarthy, *Pricing IPOs: Science or Science Fiction?*, J. OF ACCT. 51 (Sept. 1999)

<sup>18</sup> See Lawrence M. Benveniste & Paul A. Spindt, *How Investment Bankers Determine the Offer Price and Allocation of New Issues*, 24 J. FIN. ECON. 343 (1989).

control of the syndicate manager. The manager may use the pot to increase a member's allotment or to direct allocations to specific institutions or other significant investors.<sup>19</sup>

In a firm commitment offering, the sellers are compensated for their efforts through the "gross spread"—the difference between the price at which they purchase the issuer's securities and the price at which they resell those securities to the public. In recent years, the gross spread for large offerings has hovered around seven percent of the total proceeds from the offering.<sup>20</sup> The gross spread is typically allocated as follows: 20-25% to the managing underwriter, 20% to the underwriting syndicate, with the remainder going to participating dealers as a selling commission.<sup>21</sup>

### *B. Legal Regulation of the Offering Process*

Public offerings of securities are governed by the Securities Act of 1933 (the "Securities Act"), which primarily regulates the timing of selling activities and the disclosures made in promotional documents.<sup>22</sup> The disclosure regulations are organized around the creation of an offering prospectus that complies with the substantive provisions of the Securities Act.<sup>23</sup> The prospectus must be filed with and approved by the Securities and Exchange Commission (the "SEC") before any sales can take place.<sup>24</sup> This filing, which consists essentially of a preliminary version of the prospectus and a few additional pages, is referred to as the "registration statement."

The Securities Act regulates the timing of selling activities by dividing the offering into three periods around the filing and ultimate approval or "effectiveness" of

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<sup>19</sup> See Stewart, *supra* note 15.

<sup>20</sup> Compare Hsuan Chi Chen & Jay R. Ritter, *The Seven-Percent Solution*, 55 J. FIN. 1105 (2000) (attributing the seven percent commission rate to collusion) to Robert S. Hansen, *Do Investment Banks Compete in IPOs?: The Advent of the "7% Plus Contract"*, 59 J. FIN. ECON. 313 (2001) (attributing the seven percent commission rate to efficient contracting). The consistency of the seven percent gross spread in IPOs lead to a probe, eventually dropped, by the U.S. Department of Justice into potential investment bank collusion and price fixing. See Randall Smith, *U.S. Ends Probe Into Underwriting Fees Charged by Securities Firms for IPOs*, WALL ST. J., Apr. 9, 2001, at C11.

<sup>21</sup> The following mathematical illustration appears in Loss & Seligman:

For example, the underwriters may buy a million shares of stock from the issuer at \$23 and sell part of them to selected dealers at \$24 with a view to a public offering price of \$25. If the managing underwriter received a fee of one half the underwriting spread of \$1, this would mean that for each share the managing underwriter sold to the public, it would receive the entire spread of \$2 less underwriting expenses. For each share the manager sold to a dealer, it would receive the underwriting spread of \$1 minus expenses. Similarly, for each share a member of the underwriting syndicate sold at retail, it would receive the entire spread of \$2 less the managing underwriter's fee (\$.50) and underwriting expenses.

LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION*, 5<sup>th</sup> ed., 84 (New York: Aspen 2004).

<sup>22</sup> 15 U.S.C. §§ 77a-77aa (2000).

<sup>23</sup> Securities Act § 10, 15 U.S.C. § 77j.

<sup>24</sup> The SEC is creation of the Securities Exchange Act of 1934 (the "Exchange Act"), 15 U.S.C. §§ 78a-78mm (2000). Prior to the passage of Exchange Act, enforcement of the securities laws rested with the Federal Trade Commission. See JOEL SELIGMAN, *THE TRANSFORMATION OF WALL STREET* ch. 3 (1995).

the registration statement. In the first period, prior to the filing of the registration statement, offers and sales of the security, both oral and written, are prohibited. The underwriting syndicate is typically formed during this period, with the managing underwriter working with the issuer to craft the registration statement. In the second period, between filing and effectiveness, offers to sell the security are permitted, but because sales are still forbidden, no offer to buy can be accepted.<sup>25</sup> The road show, referred to above, in which the offering is promoted and indications of interest are taken, occurs during this period. Finally, once the registration statement is declared effective by the SEC, sales of the security can occur.

The predominance of the fixed price offering is *not* a function of this legal and regulatory structure. The Securities Act contains no provision requiring that securities be sold at a single fixed price. Although it does require disclosure of the price at which the securities will be sold to the public and whether any buyer other than the members of the selling group will receive a different price, the Securities Act would not prevent price discrimination as long as it was fully disclosed.<sup>26</sup> The registration statement could provide, for example, that sales of the security in lots of 1000 would be made at one price, lots of 10,000 at another (presumably lower) price, and lots of 100,000 at another, and so on. Alternately, the registration statement could provide that specified investors, perhaps favored clients of the underwriter, would receive shares in the offering at a discount to the price at which the shares were offered to the general public. This point bears repeating: neither the Securities Act nor the SEC prohibits price discrimination in IPOs.

Nevertheless, although the SEC is the primary regulator of securities markets in the United States, it has delegated some of its authority to a network of self-regulatory organizations. These include “national securities exchanges,” such as the New York Stock Exchange, and “national securities associations,” of which there is only one, the National Association of Securities Dealers (the “NASD”).<sup>27</sup> The NASD, in particular, has a significant role in regulating IPOs since they do not take place over exchanges but rather through the intermediary role of investment banks and brokerage firms, all of which belong to the NASD. And the NASD, unlike the SEC, has adopted rules that regulate the substance of IPO pricing.

Rule 2740 of the NASD Rules of Fair Practice, referred to as the “anti-discounting” rule,<sup>28</sup> prohibits the granting of discounts from the public offering price “except as consideration for services rendered in distribution” and only for “a broker or

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<sup>25</sup> See Securities Act § 5(c), 15 U.S.C. § 77e(c) (prohibiting offers prior to filing); Securities Act § 5(a), 15 U.S.C. § 77e(a) (prohibiting sales prior to effectiveness).

<sup>26</sup> Securities Act, Schedule A (requiring disclosure of “the price at which it is proposed that the security shall be offered to the public or the method by which such price is computed and any variation therefrom at which any portion of such security is proposed to be offered to any persons or classes of persons, other than the underwriters, naming them or specifying the class”).

<sup>27</sup> See Securities Exchange Act §§ 6 and 15A (delegating to exchanges and securities associations, respectively, regulatory authority over their members).

<sup>28</sup> See generally Harry S. Gerla, *Swimming Against the Deregulatory Tide: Maintaining Fixed Prices in Public Offerings of Securities Through the NASD Antidiscounting Rules*, 36 VAND. L. REV. 9 (1983).

dealer actually engaged in the investment banking or securities business.”<sup>29</sup> The result of this rule is that securities may be sold for less than the offering price (1) only to members of the selling group and even then (2) only to compensate them for services rendered in connection with the offering. Offering a portion of the gross spread to a member of the selling group, in other words, does not violate the rule, but offering a discount to any other buyer does.

Although it would seem to require that all shares in an offering be sold at a single fixed price, even the NASD’s anti-discounting rule does not prohibit price discrimination. Rule 2740 applies only to distributions designated as “fixed price offerings.”<sup>30</sup> Because the determination of whether to offer IPO shares at one price or several is made by the issuer in consultation with the managing underwriter, the rule in fact prevents discounting only once the parties have agreed to treat the distribution as a fixed price offering. They could just as easily decide not to make a fixed price offering. The anti-discounting rule, in other words, is not an anti-price discrimination rule. An issuer and its underwriting syndicate could, consistent with the rule, decide to in open price discrimination. Yet none do.

### *C. Historical Context of the Fixed Price Offering*

Some historical context may help explain the persistence of the fixed price offering in spite of a legal regime that does not mandate it. The history begins with the stock market crash of 1929 and the ensuing economic crisis. President Franklin Roosevelt took office in 1933 thanks to a campaign promising economic reform and a “New Deal” to end the depression. The Securities Act, discussed above, is one example of New Deal legislation. The National Industrial Recovery Act, signed into law soon after the Securities Act, is another.<sup>31</sup>

The broad objective of the National Industrial Recovery Act was to rehabilitate the economy through the adoption of trade and industry codes designed to promote cooperation and protect association members from competition.<sup>32</sup> The investment

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<sup>29</sup> NASD Rules of Fair Practice §2740.

<sup>30</sup> The term is defined to include U.S. offerings made “at a stated public offering price or prices,” whether or not registered under the Securities Act. NASD Rules of Fair Practice §120(h).

<sup>31</sup> Other governmental interventions in the banking and securities industry during the New Deal included, in addition to the Securities Act, the Exchange Act, and National Industrial Recovery Act, the Banking Act of 1933 (the “Glass-Steagall Act” separating commercial and investment banking), the Trust Indenture Act of 1939 (regulating distributions of debt securities), the Investment Company Act of 1940 (regulating companies engaged in the business of investing in securities of other companies), the Investment Advisors Act of 1940 (requiring registration of analysts and others providing professional advice on securities).

<sup>32</sup> See MICHAEL F. GALLAGHER, *GOVERNMENT RULES INDUSTRY: A STUDY OF THE NRA* (New York: Oxford UP 1934). Once approved by the President, violations of industry codes could be enforced in federal court. If an industry association failed to adopt a voluntary code, it faced federal imposition of an involuntary code for the industry.

banking community seized the opportunity.<sup>33</sup> Long interested in protecting underwritten offerings from the tactics of distributors who were willing to sell shares at a discount from the syndicate's agreed upon price,<sup>34</sup> the industry aimed to eliminate this form of competition through the adoption of the Code of Fair Competition for the Investment Bankers Association of America (the "Investment Bankers Code").<sup>35</sup>

The stated objective of the Investment Bankers Code, like the other National Industrial Recovery Act codes, was to promote economic recovery by "eliminat[ing] unfair competitive practices."<sup>36</sup> The real aim, however, was to protect established underwriters from discounting.<sup>37</sup> Towards this end, it contained a blunt prohibition, declaring that "[n]o participant in a selling syndicate or member of a selling group shall... offer the securities being distributed by such syndicate or group at any price below [the] public offering price."<sup>38</sup> When the National Industrial Recovery Act was

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<sup>33</sup> The investment banking industry's trade association had been in existence before the First World War. Indeed, the preference for cooperation over competition within investment banking is as old as the industry itself. According to a comprehensive history of the banking industry:

Before taking a loan [continental European investment bankers of the post-Napoleonic era] made tentative contracts with smaller houses which planned to act as middlemen.... While competition was very limited on the top level, keen competition for a share in new issues of securities by a second layer of middlemen and by capitalists enabled one concern or an alliance of several originating houses... to conclude very large deals in competition or potential competition with few others. To be sure, since the 1790's exclusion of competition had been aimed at by powerful English loan contractors also.

FRITZ REDLICH, *THE MOLDING OF AMERICAN BANKING: MEN AND IDEAS*, PART II, 320 (New York: Johnson Reprint Corp. 1968) (footnotes omitted).

<sup>34</sup> Throughout the 1920s, the group's principal concern had been the problem of competition from new entrants and the ability of such dealers to grab market share by distributing shares prior to the agreed-upon distribution period at a discount from the agreed offering price. See ARTHUR GALSTON, *SECURITY SYNDICATE OPERATIONS: ORGANIZATION, MANAGEMENT, AND ACCOUNTING* 116-123 (1928) (describing and condemning, in a volume commissioned by the Investment Bankers Association of America, "price cuttings" and a set of other arrangements used by sellers to discount the price of underwritten offerings); Paul G. Mahoney, *The Political Economy of the Securities Act of 1933*, 30 J. LEGAL STUD. 1, 9-20 (2001) (summarizing the proceedings of these conferences and the concerns of the Investment Bankers Association's membership).

<sup>35</sup> Approved Code No. 141, Executive Order No. 6456 (Nov. 27, 1933), III National Recovery Administration Codes of Fair Competition 509. The code was amended in early 1934 to include provisions government administrators described as seeking "to establish one price for all investors irrespective of the size of the transaction or the importance of the purchaser." Letter from Administrator Hugh S. Johnson to President Franklin D. Roosevelt transmitting Approved Code No. 141 -- Amendment No. 2 for approval (Mar. 23, 1934), VIII NRA Codes 659-60.

<sup>36</sup> National Industrial Recovery Act, H.R. 5755, §1.

<sup>37</sup> The goal of the Code was, in the words of a regulator:

to consistently maintain the principle of no discrimination between investors by putting all investment bankers on a level with private investors when they purchase securities solely for investment and not for distribution. It proceeds on the theory that an investment banker is entitled to a lower price than that available to the public only when that investment banker actively participates in the distribution to others of the securities in question.

Approved Code No. 141 -- Amendment No. 4, Report to the President and Order (Feb. 27, 1935), XXI NRA Codes 433.

<sup>38</sup> Investment Bankers Code Committee, Code of Fair Competition for Investment Bankers, art. V, § 4(a).

voided on constitutional grounds,<sup>39</sup> the investment banking industry simply reorganized and re-issued the prohibition. The Investment Bankers Association of America became the Investment Bankers Conference and then, in 1938, the NASD, the primary regulator (under SEC supervision) of the securities industry.<sup>40</sup> The NASD immediately adopted anti-discounting rules, in essentially the same form as they had existed under the Investment Bankers Code.<sup>41</sup>

As a result, investment banks were subject to a broad rule prohibiting any form of discounting. But the real target of the rules was the institutional investor.

The role of financial institutions—banks, mutual and pension funds, and insurance companies—as equity investors has steadily increased over the last century.<sup>42</sup> Studies now report that institutional investors purchase 70-85% of the shares offered in IPOs.<sup>43</sup> From the underwriters' perspective, institutions are highly desirable buyers because institutional investors can buy large quantities of shares, quickly spreading the risk of a firm commitment offering. They are also repeat players in the new issue market, providing underwriters with a reliable buyer in various market climates.

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<sup>39</sup> In May 1935, less than two years after its enactment, the U.S. Supreme Court declared the National Industrial Recovery Act unconstitutional on non-delegation grounds. See *A.L.A. Schechter Poultry Corp. v. United States*, 295 U.S. 495 (1935) (holding that the act impermissibly delegated legislative authority to the executive).

<sup>40</sup> This occurred as an amendment to the Exchange Act, known, after its sponsor as the Maloney Act, passed. 52 Stat. 1070 (1938) (codified as amended at 15 U.S.C. §78o-3 and generally known as §15A of the Exchange Act). See generally Marianne K. Smythe, *Government Supervised Self-Regulation in the Securities Industry and the Antitrust Laws: Suggestions for an Accommodation*, 62 N.C. L. REV. 475, 484 (1984) (describing this period). The Act made the NASD, subject to SEC approval, the primary regulator of the securities industry.

<sup>41</sup> See *In re Application by National Association Of Securities Dealers, Inc. for Registration as a National Securities Association*, Exchange Act Release 2211, 1939 SEC LEXIS 659; 5 S.E.C. 627 (Aug. 7, 1939). The Exchange Act still retains the provision of the Maloney Act granting express authority to national securities associations to make rules preventing members from distributing securities to a non-member except on the same terms and conditions under which the securities would be offered to the public. See Exchange Act §15A(e)(1), 15 U.S.C. §78o-3(e)(1).

<sup>42</sup> See, e.g., Bernard S. Black, *Agents Watching Agents: The Promise Of Institutional Investor Voice*, 39 UCLA L. REV. 811 (1992).

<sup>43</sup> See Beatrice Boehmer, *et al.*, *Do Institutions Receive Favorable Allocations in IPOs with Better Long Run Returns?* (March 1, 2005), <http://ssrn.com/abstract=350720>, at 12 (reporting findings that “the median allocation to institutional investors is 86% of Lead allocations and 77% of total allocations” and that “institutional investors receive about 75% in underpriced and 68% in overpriced issues” or, in other words, institutional investors receive the lion’s share of most IPO allocations but significantly less in IPOs that are overpriced); Kathleen Weiss Hanley & William J. Wilhelm, Jr., *Evidence on the Strategic Allocation of Initial Public Offerings*, 37 J. Fin. Econ. 239, 240 (1995) (finding over a sample of 38 IPOs during the period 1983-88 that “approximately 70% of the shares in underpriced offerings are allocated to institutional investors”); Ljungqvist & Wilhelm, Jr., *supra* note 5 (“Averaging across 37 countries and 1,032 IPOs between 1990 and 2000, we find that share allocations to institutional investors are virtually double those received by retail investors.”); Letter from Jane C. Sherburne, Deputy General Counsel of Citigroup, Inc., to Michael G. Oxley, Chairman of the House Committee on Financial Services & John J. LaFalce, Ranking Member of the House Committee on Financial Services (Aug. 26, 2002) (responding to Aug. 23, 2002 subpoena and stating, “In the typical IPO, the percentage of offered shares allocated to institutional investors generally ranges from 70% to 85% of the total shares.”).

Because of these attributes, institutional investors also have significant bargaining power in public offerings. Not surprisingly, institutions have sought to use this bargaining power to win discounts from the public offering price. By the 1960s, a standard set of discounting techniques had emerged that sellers could use to bestow benefits upon institutional buyers. These included “overtrades,”<sup>44</sup> “soft dollar arrangements,”<sup>45</sup> and tying arrangements used to “recapture” the sellers’ discount.<sup>46</sup>

By the mid-1970s, these forms of discounting had become so common that a U.S. District Court held that it was a breach of fiduciary duty for an institutional investor’s directors *not* to have received some form of discount from the sellers. In *Paplinsky v. Berndt* the court rejected the fund managers’ defense that recapture and other forms of discounting were illegal, holding that without a clear NASD rule to the contrary, recapture was legally permissible and, therefore, that failing to negotiate for it was a potential breach of fiduciary duty.<sup>47</sup> In an effort to show that there was indeed a clear rule to the contrary, the fund managers wrote to the NASD for a formal opinion. When the NASD replied that it did indeed interpret its existing rules to prohibit recapture, the SEC intervened, declaring that it considered this interpretation a change in NASD rules and invoking its authority under the Exchange Act to approve NASD rule changes.<sup>48</sup> The result of the rule-making process that followed was a clarification of the anti-discounting principle that the NASD had sought to implement from the moribund Investment Bankers Code. The NASD rules were revised to expressly forbid overtrades as well as soft dollar and recapture arrangements.<sup>49</sup>

After *Paplinsky*, it became clear that the NASD rules are designed to neutralize the ability of institutional investors to win private discounts in fixed price offerings. The

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<sup>44</sup> Overtrades take place as part of a swap arrangement. In a swap, institutional investors receive shares in an underwritten offering in exchange for securities rather than cash. Swapping accomplishes discounting when the securities the underwriter takes in exchange are worth less than the value of the share allocation from the offering. For example, an institutional investor could secure an effective discount of 5% by trading bonds worth \$95,000 for an IPO allocation worth \$100,000. The “overtrade” refers to the value of the IPO shares given in excess of the value of the securities taken in the trade and amounts to an effective discount from the offering price for the institutional buyer.

<sup>45</sup> Soft dollar arrangements arise when an institution pays the same amount for IPO shares as a member of the general public but also receives, in consideration of the institution’s participation in the offering, a good or service from the seller, free of charge, for which others would have to pay. The most common soft dollar arrangement involved brokerage firms’ research and analysis. Institutions that invested in offerings sold by the brokerage firm would receive free research and analysis while others were made to pay for the same services. Soft dollar arrangements thus discount the offering price for participating institutions by an amount equal to the value of the services provided. See Gerla, *supra* note 28, at 14, n. 25.

<sup>46</sup> Institutions could recapture the sellers’ commission by insisting that an affiliated brokerage firm be included in the selling group. The seller would then purchase shares through its affiliate and effectively receive the discount given to the affiliate for making the sale. See LOSS & SELIGMAN, *supra* note 21, at 1173-74 (describing these discounting techniques). The sellers’ discount is described above at note 21 and accompanying text.

<sup>47</sup> 1976-1977 Fed. Sec. L. Rep. (CCH) ¶ 95,627 (S.D.N.Y. 1976).

<sup>48</sup> Exchange Act Release No. 15807 (May 9, 1979).

<sup>49</sup> The amended rules prohibit overtrades by providing that securities “taken in trade” must be exchanged at “a fair market price” and involve a “normal commission.” NASD Rule of Fair Practice 2730. The rules target recapture by preventing brokerage firms from selling securities to affiliates unless the affiliate is also subject to NASD anti-discounting rules. NASD Rule of Fair Practice 2750.

anti-discounting rules show a protectionist trade association acting to preserve its bargaining power vis-à-vis its most serious potential adversary, the institutional investor. The bargaining power of an institutional investor may be strong enough to force an individual dealer to share its selling discount with the institution, lest the institution find another securities firm that is willing to do so. Against the syndicate as a whole, however, the bargaining power of the institutional investor is constrained. By adopting rules to force all syndicate members to act as a cohesive group, any institutional investor may be faced with a take-it-or-leave-it price and, lest the investment opportunity be offered to a competing institution, feel pressured to take it. The NASD rules, in other words, effectively implement a collective bargaining arrangement, forcing institutional buyers to bargain with the underwriting syndicate as a whole, effectively muting the bargaining power of the institutional investor.

But again, the anti-discounting rules only apply to IPOs designated as fixed price offerings. As described above, the sellers could choose to engage in a discriminatory offering and, as long as the different prices were fully disclosed in the offering documents, proceed in compliance with all securities laws and regulations. Still, none do. All shares in a given IPO are sold at a single fixed price.

The apparent lack of price discrimination, however, may mask a deeper level at which a form of implicit price discrimination is at work. Institutions and individuals pay the same price for the shares they receive in an IPO, but the shares they receive are not exactly the same. Instead, individuals' allocations of IPO shares tend to be burdened by resale restrictions imposed on them by the underwriter, while shares received by institutions are not. This form of *implicit* price discrimination is explored in the next section.

### **III. Bargaining Power and Implicit Price Discrimination**

A securities offering reflects a bargain between issuer, underwriter, and investor. In the bargain, the underwriter retains discretion over the allocation of shares. Because underwriters control IPO allocations, they can use share allocations to create benefits for themselves. The preferential allocation, or "spinning,"<sup>50</sup> of IPO shares has recently been used by underwriters to stimulate brokerage business,<sup>51</sup> generate political favors,<sup>52</sup> and

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<sup>50</sup> See Michael Siconolfi, *The Spin Desk: Underwriters Set Aside IPO Stock for Officials of Potential Customers*, WALL ST. J., Nov. 12, 1997, at A1. See also Francois Degeorge, et al., *Quid Pro Quo in IPOs: Why Book-Building is Dominating Auctions*, ECGI - Finance Working Paper No. 65/2005; FEEM Working Paper No. 150.04; RICAFA Working Paper No. 011, available at <<http://ssrn.com/abstract=582963>> (January 2005) (arguing that book-building is the dominant means of raising capital because it is favored by underwriters due to the quid pro quo trades it allows them).

<sup>51</sup> See, e.g., News Release, National Association of Securities Dealers, Inc., NASD Charges Robertson Stephens with Sharing in Millions of Dollars of Customers' Profits in Exchange for "Hot" IPO Shares (Jan. 9, 2003) (announcing settlement tying IPO allocations to excess brokerage commissions); SEC Litigation Release No. 17327 (Jan. 22, 2002) (same). See also Susan Pulliam & Randall Smith, *CSFB Officials Set Quota for Repayment of IPO Profits in Form of Commissions*, WALL ST. J., Aug. 10, 2001. See also Nimalendran, et al., *Are Trading Commissions a Factor in IPO Allocations?*, AFA 2005 Philadelphia Meetings Paper (October 20, 2004), available at <<http://ssrn.com/abstract=644041>> (finding that they are).

induce concessions on offering price.<sup>53</sup> Preferential allocations can also be used to appeal to institutional investors.

Underwriters prefer institutional investors for the institutions' ability quickly to relieve underwriters of the risk of the offering and for the fact that institutions can be counted upon as repeat players in the new issues market.<sup>54</sup> As a result of their preferred status, institutional investors are in a position to demand a concession in the bargain. This concession, financial economists have argued, is the underpricing of new issues.<sup>55</sup> As noted above, IPO shares sold in the primary market are frequently sold at a large discount from (and therefore "underpriced" relative to) the price at which they will immediately trade in the secondary market.<sup>56</sup> Underpriced shares, obviously, are a prized investment opportunity, and it is not surprising that institutional investors, given their importance in the primary market, receive preferential treatment from underwriters making IPO allocations.<sup>57</sup> But the concession offered to institutional investors is in fact more than just preferential allocations of underpriced shares. Institutional investors also receive IPO shares that are unburdened by the resale restrictions imposed on other buyers.

Underwriters typically impose resale restrictions on IPO shares to prevent buyers from selling, or "flipping" their shares in the immediate aftermarket and thereby exerting downward pressure on price. By constraining liquidity in the immediate aftermarket, the underwriter ensures that the offering price will hold at least until the distribution is

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<sup>52</sup> See, e.g., Amy Borrus, *The Recruit Scandal Bubbles to the Top*, BUS. WK., Mar. 20, 1989, at 55 (describing the allocation scandal that engulfed Japanese Prime Minister Noboru Takeshita).

<sup>53</sup> See Sean J. Griffith, *Spinning and Underpricing: A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings*, 69 BROOK. L. REV. 583 (2004) (arguing that spinning and underpricing are related though the use of preferential allocations to induce issuers' managers to make concessions in the pricing of their own offerings).

<sup>54</sup> See *id.*, at 630-32 (describing importance of institutional investors in the new issues market).

<sup>55</sup> Underwriters must underprice new issues in order to cause institutions to place orders that accurately reveal demand for the offering. This theory of underpricing originated with Benveniste & Spindt, who remarked:

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

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 Lawrence M. Benveniste & William J. Wilhelm, *A Comparative Analysis of IPO Proceeds under Alternative Regulatory Environments*, 28 J. FIN. ECON. 173 (1990). Empirical findings support that where bookbuilding is used, institutions receive preferential allocations. See Reena Aggarwal, *et al.*, *Institutional Allocation in Initial Public Offerings: Empirical Evidence*, 57 J. FIN. 1421 (2002) (finding evidence of favoritism of institutional investors using U.S. data); Hanley & Wilhelm, *supra* note 43 (same); Francesca Cornelli & David Goldreich, *Bookbuilding and Strategic Allocations*, 56 J. FIN. 2337 (2001) (same using U.K. data).

<sup>56</sup> See Ritter & Welch, *supra* note 3.

<sup>57</sup> Underpricing is costly to issuers who, as a direct consequence, raise fewer proceeds (or suffer greater dilution) in the offering. Financial economists have explained underpricing as a function of the agency problem between issuers and their underwriters. See Tim Loughran & Jay R. Ritter, *Why Don't Issuers Get Upset About Leaving Money on the Table in IPOs?*, 15 REV. FIN. STUD. 413 (2002).

complete. However, these anti-flipping restrictions are not imposed equally on all shares or investor classes. Instead, institutional investors' allocations are frequently unburdened by these restrictions, while individual allocations are, preventing resale for a period of up to six months following the offering.<sup>58</sup> This asymmetrical imposition of resale restrictions is plainly intended to induce the goodwill of institutional investors who, as a result, are guaranteed the opportunity either to liquidate a losing investment or to realize gains immediately. Similarly, when the underwriter engages in spinning, these allocations, whether to individuals or institutions, are unburdened by anti-flipping restrictions.<sup>59</sup> As a result, favored individuals receive shares that they can sell immediately, while the rest receive shares with resale restrictions.

This allocation procedure, quite simply, is a form of price discrimination.<sup>60</sup> Although all buyers purchase shares at the same price, shares that are burdened by resale restrictions are worth less than shares that are not. Institutions and a few favored individuals therefore receive more for their money than most individual investors. In other words, disfavored individuals effectively pay more for their IPO allocations than institutional investors. This is precisely the form of price discrimination that was hypothesized above to maximize returns for the seller, here the underwriter.

Price discrimination, in other words, *does* occur in the new issues market. When an underwriter allocates shares at the same price, some of which are burdened with resale restrictions and some of which are not, it is engaging in price discrimination. The difference between this form of price discrimination and that described above is that it is implicit rather than explicit discrimination. The pricing differences take the form of *sub rosa* trades rather than different allotments sold for different prices. The key to recognizing this form of price discrimination lies in understanding the control that the underwriter exerts over the offering process. Underwriters can maximize their returns by underpricing offerings and selectively granting allocations unburdened by resale restrictions.

But if price discrimination does indeed occur, why must it be implicit rather than explicit? Since there is no legal obstacle to selling different allotments at different prices, why not simply do so rather than relying upon a system of implicit promises and favors?

It is here, as in the case of the anti-discounting rules, that the answer returns to distributional concerns and bargaining power. As long as price discrimination is implicit,

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<sup>58</sup> Reena Aggarwal, *Allocation of Initial Public Offerings and Flipping Activities*, 68 J. Fin. Econ. 111 (2003) (finding that institutions engage in flipping more than individuals); Lawrence M. Benveniste, *et al.*, *Who Benefits From Secondary Market Price Stabilization of IPOs?*, 22 J. BANK. & FIN. 741 (1998) (finding that penalty bids primarily constrain individuals); Laurie Krigman, *et al.*, *The Persistence of IPO Mispricing and the Predictive Power of Flipping*, 54 J. FIN. 1015 (1999) (finding more flipping by institutions than individuals).

<sup>59</sup> *See id.*

<sup>60</sup> *See* Alexander P. Ljungqvist, *et al.*, *Hot Markets, Investor Sentiment, and IPO Pricing*, (Nov. 6, 2003), AFA 2004 San Diego Meetings; Twelfth Annual Utah Winter Finance Conference; Texas Finance Festival, available at <<http://ssrn.com/abstract=282293>> (arguing that underwriters use discretion over allocations to engage in tacit price discrimination).

the underwriter controls it and, therefore, enjoys the benefits. If price discrimination were made explicit, however, the benefits would redound to the issuer.

Explicit price discrimination would be achieved by pricing each IPO allocation at the price each buyer was willing to pay. Because individuals have shown themselves willing to pay more than institutions, this presumably would mean charging a higher price for shares sold to individuals rather than institutions.<sup>61</sup> Increasing share price would result in increasing the offering proceeds, which would plainly benefit the issuer. Meanwhile, institutional investors, the current beneficiaries of underpricing and relaxed anti-flipping restrictions, may be no worse or better off. Underwriters, however, stand to be made worse off.

Explicit price discrimination—charging different prices to different classes of buyers—would eliminate the benefits derived from the underwriter’s ability to control allocation decisions. If each allotment was priced differently, all buyers would effectively pay for what they received, eliminating the ability of underwriters to bestow the benefit of underpriced shares. Because the ability to bestow such benefits to favored investors is the basis of the underwriter’s ability to profit from implicit price discrimination, explicit price discrimination would effectively cut the underwriter out of the loop. Open price discrimination, in other words, would redistribute the marginal benefit of controlling allocations—that is, the value of consumers’ surplus in IPOs—from underwriters to issuers. It would not, therefore, be surprising if underwriters opposed it.

If underwriters viewed the capture of consumers’ surplus as an important component of their overall compensation in an offering, of course, they could simply insist on increasing their compensation—the spread—in the underwriting arrangement. It is here that the story becomes one of market failure. Underwriting is effectively a cartel business—hence the term “syndicate.” Because they control the threshold to the capital markets, underwriters have more bargaining power in the offering process than any other participant. Moreover, by acting as a cohesive unit, underwriters have managed to protect their commissions from the bargaining power of individual investors through the enactment of the anti-discounting rules. Underwriters have also used their market power to effectively fix the gross spread of large public offerings and to stymie innovation in the offering process.<sup>62</sup> It would therefore not be surprising if this cartel used their bargaining power to prevent issuers from engaging in explicit price discrimination, thereby ensuring that the underwriters’ total compensation remains hidden. The loser in this bargain is the issuer and, of course, the transparency and efficiency of the primary market.

## **Conclusion**

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<sup>61</sup> *See id.* (noting that the demand function for individual investors is often determined by sentiment rather than a dispassionate appraisal of the risk-return blend offered by the security).

<sup>62</sup> *See supra* note 20 (discussing the persistence of the seven percent gross spread as a result of cartelization); Randall Smith, *Why IPOs Still Use the Old Way*, WALL ST. J., Jul. 6, 2005, at C1 (discussing failure to adopt Dutch auction methods for IPOs as a result of underwriter resistance).

This chapter has investigated the mysterious persistence of the fixed price offering in the United States. After describing the general economic theory and developing a basic model of price discrimination, it investigated the actual operation of the IPO market, where explicit price discrimination is conspicuously absent. It then argued that the absence of explicit price discrimination is not the result of a legal mandate but rather is the result of the market power of the underwriter, which has used its control of the offering process to discourage explicit price discrimination while maximizing its returns through implicit price discrimination.