



QUEEN'S UNIVERSITY
LAW AND ECONOMICS WORKSHOP

IS THE DUTCH AUCTION IPO A GOOD IDEA?

By

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ABSTRACT

The Google IPO raised the question of whether Dutch auctions are preferable to the traditional bookbuilding method of financing. Some argue that Dutch auctions make public offerings more efficient in terms of price discovery by leaving less money on the table. They further argue that Dutch auctions are more fair, since underwriters do not allocate securities to preferred clients, thereby allowing for a more equitable allocation among institutional and retail investors. I suggest that the Dutch auction is not necessarily more fair and may in fact lead to less efficient capital markets. I argue that reform of the current system is unnecessary because of capital market composition and, in particular, the means by which a majority of retail shareholders invest in securities.

1. Introduction

In the aftermath of the much-hyped Google IPO, a nagging question is whether the Dutch auction method of offering securities is a positive development in corporate finance. Some argue that the transaction improves both pricing and allocation, the two primary functions of the underwriter. The theory is that in the Dutch auction, price is based solely on demand. Further, retail investors – not simply institutions – are able to buy into the offering, making the allocation more fair. However, these features of the Dutch auction may not be benefits at all.

I argue that we should not alter existing regulation to facilitate Dutch auctions in the offering context, for two reasons. First, the Dutch auction may be susceptible to underpricing. Second, fairness in allocation in the offering process may not lead to positive outcomes overall, given that uninformed retail investors will contribute to market inefficiencies. From a policy perspective, the analysis favors existing regulation and the application of the fiduciary duty concept, including the corporate opportunity doctrine. In markets where a majority of retail investors hold securities in mutual funds, it seems unnecessary to alter current regulation.

In traditional auctions, the price rises until one bidder is left. In a Dutch auction, price descends depending on the bids received. The price is initially set high, and gradually lowers depending on the number of shares to be sold. In setting the

price, the issuer does not use an underwriter but, rather, establishes a price range and the maximum number of shares to be sold under the offering. Investors bid on the offering by stating the number of shares they want to purchase and their preferred price within the pre-established range. Once the bids have been submitted, the issuer determines a “clearing price,” which is the price at which it will sell the shares. This is the highest price within the established range at which the issuer can sell the pre-specified number of shares. Thus, there is no intermediary and the issuer has discretion over price and allocation.

My arguments relating to fairness and efficiency are strongest when applied to firms that are not generally well-known and followed. Thus, much of the discussion that follows relates to firms completing their IPOs using Dutch auctions as opposed to firms that are widely traded using a Dutch auction for an additional issue. I argue that for widely-traded issuers that are well-known to the market, Dutch auctions may indeed be efficient for additional issues of equity and debt securities, since information asymmetries are less pronounced when seasoned issuers are involved.

This paper makes a significant contribution to existing legal literature in its in-depth comparison of the bookbuilt versus the Dutch auction mechanism. It also presents a cogent argument regarding the inefficiency of the Dutch auction IPO that differs from mainstream thinking regarding these transactions. Finally, in

examining the idea that IPO markets may be considered to be public goods, the paper adopts a novel approach to analyzing fairness in the offering process.

The paper proceeds as follows. Part 2 reviews arguments relating to efficiency and fairness in the context of innovative securities offerings such as the Dutch auction. Part 2 also considers the issue of whether the capital markets can be understood to be a public good. Part 3 discusses reasons for the endurance of the bookbuilt mechanism and recent empirical evidence relating to the desire among firms to use an underwriter when offering securities. Part 4 discusses directions in which legal reforms should develop in order to respond to the fairness concerns raised in Part 2. Part 5 concludes.

2. Efficiency and Fairness in the Dutch Auction

a. Efficiency

In a traditional bookbuilt offering, establishing price is a process that depends on the underwriter's analysis of the issuer and its determination of the worth of the securities. Price is based on a number of variables, including valuations of the issuer and the securities to be issued, the success of the "roadshow," process and the corresponding level of apparent demand for the offering. Bookbuilt offerings are not typically open to the retail investor but are available primarily to institutions and their clients.

In an offering, the issuer generally wants to receive the highest possible price for its shares. Underwriters, however, have an incentive to underprice the shares to ensure that they can sell the offering, and, unsurprisingly, there is extensive evidence that IPOs are, on average, underpriced. These studies report that IPOs achieve sizable average returns over very short periods, which leads to the conclusion regarding underpricing.¹ When shares are underpriced, money is “left on the table”; in other words, the purchaser would have been willing to pay more for the shares. While underpricing is reflected in the purchase price of the new issue of securities, technically speaking it is the discount arising from selling the securities below their closing value on the first day of trading. The practical result is that the price of the securities experiences a “pop” on the first day of trading.

By contrast, in a pure Dutch auction, the issuer does not use an underwriter to price the offering. Any bidder that bid at or above the clearing price is successful, and if investors seek to buy more shares than are being offered, the issuer divides them *pro rata* among the bidders at the clearing price. If investors bid over the ultimate clearing price, they will be able to purchase at the clearing price, but they may not receive as many shares as they requested. Rather, the issuer will allocate the shares *pro rata* to all bidders who bid at the clearing price

¹ See Jay R. Ritter, *The “Hot Issue” Market of 1980*, 57 J. BUS. 215 (1984); Roger G. Ibbotson & Jeffrey F. Jaffe, *“Hot Issue” Markets*, 30 J. FIN. 1027 (1975). See also Judith S. Ruud, *Underwriter Price Support and the IPO Underpricing Puzzle*, 34 J. FIN. ECON. 135 (1993).

or above. For example, in a Dutch auction, the issuer offers to sell 15 shares. Investor A bids for 10 shares for \$10. Investor B bids for 10 shares for \$8. Investor C bids for 10 shares for \$6. The issuer sets the clearing price at \$8. Thus, investor A gets 7.5 shares and Investor B gets 7.5 shares; investor C receives no allotment, because she bid under the clearing price. Some Dutch auctions vary this process by filling all bids above the price level selected and prorating only bids at the price level.

These are the key features of the Dutch auction: investors choose their preferred price based on their assessment of the stock's worth, and they need not be affiliated with an investment bank to participate in the offering; rather, the issuer sets the price based on the number of shares it wishes to sell and the bids that it receives for those shares. The issuer does not offer the securities for different prices; it establishes one price based on demand. If demand for the shares is low, the clearing price will be set at the lower end of the range, and vice versa if demand is high. This process supports the argument that the Dutch auction is an efficient pricing mechanism. Price is a direct result of competitive bidding and gives a more accurate indication of demand than the bookbuilding method.

Issuers have modified the pure Dutch auction by retaining investment banks to perform some, but not all, of the functions of the traditional bookbuilt offering. For example, in its IPO Google Inc. retained two investment banks to assist in

establishing the price range. The investment banks then carried on limited roadshows to gauge demand. However, the bidding itself occurred over the Internet and included anyone who met certain conditions set out in the Registration Statement (*e.g.*, establishing US residency, obtaining a bidder identification from www.ipo.google.com, and opening an account with a brokerage firm affiliated with one of the underwriters).

It stands to reason that the extent of underpricing should be less in the Dutch auction than in the bookbuilt IPO, since price discovery is determined on the basis of market demand alone, with no intermediary present. Furthermore, Dutch auctions are able to incorporate more information about historical and current market conditions than the bookbuilding method.² This seems plausible, since in the bookbuilding method, the pricing of the issue is kept confidential until the offering occurs. In a Dutch auction, in theory, no money will be left on the table.³

However, underpricing can exist even in the Dutch-auction context.⁴ For example, Andover.net went public in 1999 via the Dutch-auction method. On the

2 François Derrien & Kent L. Womack, *Auctions vs. Bookbuilding and the Control of Underpricing in Hot IPO Markets*, 16 *The Review of Financial Studies* 31 (2003), “Conclusion” section.

3 Derrien & Womack, *id.*, examine the French stock market between 1992 and 1998 and show that the auction mechanism is associated with less underpricing and lower variance of underpricing.

4 In addition to this argument, see Saul Hansell, *For Google, Going Dutch has Its Rewards and Its Risks*, *The New York Times*, May 10, 2004 at C1.

first day of trading, the offer price of \$18 per share⁵ increased to \$78.8125.⁶ Less dramatically, Genitope went public via a Dutch auction in 2003 with an offering price of \$9 per share. On the first day of trading, the stock closed at \$12.50 per share. Google also experienced a significant rise in its offer price on the first day of trading after having adjusted its price range downward prior to the IPO. Prior to the offering, Google adjusted its original price range of \$108–\$135 to \$85–\$95 per share.⁷ On the first day of trading on the NASDAQ, Google’s share price rose from \$85 to \$100.34. In May 2005, Morningstar Inc. completed its IPO. The offering price was set at \$18.50 per share and closed its first day of trading at \$20.05 per share.⁸

In both the Andover and Google IPOs, there is room to question whether the offering price entirely encapsulated demand.⁹ Further, the fact that Google went to market at the bottom of the second range of prices chosen also suggests an

5 Edgar Filing, Andover.net Prospectus under Rule 424(b)(1), 8 Dec 1999, at <<http://www.sec.gov/Archives/edgar/data/1093580/0000950135-99-005524.txt>>. This filing stated 4 million shares at \$18/shr.

6 Lawrence M. Fisher, *A Tiny Company Without Profits Goes Public*, New York Times, December 10, 1999 at C1. See also NASDAQ National Market Stock Quote at C11 – Note Stock Closing Prices for the week – December 9, 1999, \$64 at C20; December 11, \$68 at C7; December 14, \$52 at C17. All prices are as indicated for the previous trading day.

7 Note, however, that Google, because of its well-known product, is one of the few companies that could have emerged successfully from its modified Dutch-auction IPO. Other issuers might not have been as successful in the Dutch auction process. See Anita Anand & Lewis Johnson, *The Role of Underwriters in Non-traditional Offerings: Empirical Evidence*, Queen’s Univ. Law & Economics Research Paper No. 2005-05 (2005), at <<http://ssrn.com/abstract=653863>>.

8 Over its first week of trading, Morningstar traded as high as \$23.45 per share, and it is currently trading for \$21.90 per share (as of closing on May 12, 2005).

9 Some may argue that the Google Dutch auction failed. Another point of view, however, is that Google went to market with the lowest price in the range in order to stimulate demand. See Laurie Simon Hodrick, Google’s IPO: A Dutch Auction Works, If You Let It, *Columbia Business School: Hermes Magazine* (Fall 2004), at <www2.gsb.columbia.edu/hermes/fall2004/article_google.cfm>.

attempt to create demand for the issue. The company itself warned, “If we satisfy the demand for our shares at or near the clearing price for the auction, market demand for our shares may be significantly limited ...”¹⁰ Dutch-auction issuers also seek to avoid the possibility of a “winner’s curse,”¹¹ a situation in which successful bidders believe that they overpaid for their shares and therefore seek to divest themselves of the assets prior to an expected decline in the price of the shares.¹²

Given the large spike in price following past auction transactions, we should question whether the Dutch-auction method leads to accurate price discovery. Jagannathan and Sherman report that auction prices are often highly inaccurate, with large positive and large negative first-day returns.¹³ As an example, they point to the 2003 auction for El Al shares in Israel, in which demand was low and all shares sold at the minimum bid. Two days later, on the Tel Aviv stock exchange, the shares closed at 112% higher than the offer price. The authors

10 Google Inc., Form S-1 Registration Statement as filed with the Securities and Exchange Commission on April 29, 2004, at 18.

11 Google Inc., Registration Statement, prospectus describing the winner’s curse in which “bidders win auctions by over paying.” See Eric J. Savitz, *Google This: Winning Bidders of Breathlessly Awaited IPO Should Search Winner’s Curse*, Barron’s, May 3, 2004, at 17. See Jacqueline Doherty, *Rich Price, Poor Value*, Barron’s, August 2, 2004, at 12: “Pundits talk about a winner’s curse in Dutch auctions, because shares often trade down in the aftermarket once investors willing to pay top dollar hold the stock.”

12 Again, Google cautioned investors that “submitting successful bids and receiving allocations may be followed by a significant decline in the value of their investment ...” Thus Google set its offer price below the clearing price in order to ensure that demand and price would escalate simultaneously.

13 Ravi Jagannathan & Ann E. Sherman, *Reforming the Bookbuilding Process for IPOs*, 17/1 Journal of Applied Corporate Finance 2, 6 (2005).

contrast this with the case of Japan Tobacco, in which share prices fell 23.5% on the first day of trading and then continued to fall.¹⁴

The bookbuilt offering may even result in a higher price than the Dutch auction. One of the functions of the underwriter is to create awareness through the roadshow process and their other selling efforts. Underwriters have a network of clients and may be able to generate greater interest than is possible in the Dutch auction (especially the pure Dutch auction, where no underwriter is present). Of course, the result of greater demand is higher proceeds to the issuer.

Furthermore, the fact that underwriters attract a higher percentage of stable institutional investors than is found in a Dutch auction likely has a bearing on capital market efficiency. Retail shareholders typically do less research and diligence in making their investment decision and in determining the price they are willing to pay than a sophisticated institutional investor.¹⁵ They also 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

14 *Id.* at 7. It appears from the Japanese transaction that investors may have sought to “flip” their shares or, at least, that when the share price did not “pop” sellers emerged from the initial purchasers. It may be that little attention was given to aftermarket support, which underwriters offer.

15 See Francesca Cornelli, David Goldreich, & Alexander Ljungqvist, *Pre-IPO Markets*, EFA 2003 Annual Conference Paper No. 968 (2003), at <www1.fee.uva.nl/fm/PAPERS/papercornelli.pdf>, stating that “In the literature, the exclusion of retail investors from bookbuilding has typically been justified by arguing that retail investors are uninformed and it is optimal to restrict the participation in bookbuilding to the (informed) institutional investors.”

investors can make the market less efficient. Dutch auctions may not therefore be superior in terms of price discovery, as many have suggested.

Underwriters also undertake significant “groundwork” for otherwise passive investors by highlighting the existence of the investment opportunity, providing the preliminary prospectus, and encouraging investment. Arguably, in order for the Dutch auction to succeed, investors must be more active than in the bookbuilt offering, and the company completing the IPO must be well known to them (as was Google). The Dutch-auction investor will be one who seeks out investments and is able to bid on the securities without the underwriter’s assistance. Relatively speaking, this investor must put forth more effort to understand the transaction and complete the purchase. In light of investor passivity, therefore, the bookbuilt method is likely more effective in creating investor interest in the transaction.

While the bookbuilt method can be criticized for giving rise to the practices of spinning (underwriters’ practice of allocating coveted IPO shares to existing clients in return for higher commissions or future business) and laddering (pressuring investors who purchased IPO shares to buy more at higher prices once the shares begin to trade), the auction process has a potential downside in that it allows bidders to adopt strategies that manipulate the pricing of

securities.¹⁶ First, a bidder can bid on the shares at a price higher than what she perceives the value of the shares to be, thereby increasing her chances of success in the purchase. The risk in undertaking this strategy is that the clearing price may not be lower than the bidding price and therefore the bidder may overpay. Second, the bidder can underpay, or bid at a price lower than what she perceives the value to be. The risk here is in losing the bid, not in overpaying. Third, the bidder can bid for more shares than she wants and will likely bid under the perceived value.¹⁷

Even if price discovery in the Dutch auction is efficient and accurate, with no collusion or other manipulative bidding, issuers themselves may seek to avoid some of the negative effects of auctions, for their own benefit as well as investors'. They recognize that sophisticated parties, such as institutional investors and day traders, may refrain from participating in these transactions, since they are aware that underpricing will be less severe, and will put their money in bookbuilt IPOs where they have a better chance to benefit from the

16 These strategies differ from the “free-rider” problem, where the bidder deliberately bids high and relies on the efforts of others to price the offering more accurately, thus guaranteeing a larger proportion of the shares at the set offering price. As noted, this leads to inefficiency, as it lowers the informed trader’s incentive to become informed and to set an accurate price. In terms of manipulative bidding, bidders may collude rather than make the bid at the highest price with which they as individuals are comfortable. See Bruno Biais & Anne Marie Faugeron-Crouzet, *IPO Auctions: English, Dutch, ... French, and Internet*, 11 *Journal of Financial Intermediation* 9, 13 (2000).

17 Mira Ganor, *A Proposal to Restrict Manipulative Strategy in Auction IPOs* (July 2004), at <<http://ssrn.com/abstract=572243>>.

proven underpricing that occurs there.¹⁸ As the investing public becomes more and more sophisticated, the Dutch auction may decrease in popularity.

One of the factors that will affect a decision about whether to “go Dutch” is the percentage of stock the issuer seeks to sell. If the issuer seeks to sell 100 % of a class of shares, then price will be the most important factor – specifically, obtaining the highest possible price. However, if the firm seeks to sell only a fraction of the shares in a class, price will likely not be the overriding concern. Rather, the issuer will be concerned to ensure that analysts will follow the company and that the stock will appreciate after the fact, since it will be coming back to the market repeatedly. The traditional bookbuilt process provides certain long-term benefits in this respect. Pricing is based largely on demand, but not only on demand. The pure Dutch-auction method does not ensure analyst following and similar long-term benefits. In a pure Dutch auction, price is the main concern and is based on market demand alone.

Unless the issuer is well established, as was Google, there will be uncertainty about the number of investors that will participate. The auction offering price is more likely to be noisy, which can lead to market instability for the new issue

18 John C. Coffee, *IPO Underpricing and Dutch Auctions*, 55 NYLJ 5 (Col.) 1, (1999) who states “If, however, IPO underpricing results primarily from day trading excesses or systematic biases in the market, Dutch auctions may prove unsuccessful, as day traders and institutions will avoid such transactions, hoping instead to profit from deliberate underpricing in more traditional IPOs.”

when it opens.¹⁹ Many auction problems have been blamed on either too many or too few bidders entering the auction.²⁰ Without question, it will be more difficult for a small cap company to complete a Dutch auction because it will have difficulty in ascertaining who will invest. The underwriter's market-making role is one that is difficult for the issuer to play on its own. As Jagannathan and Sherman state, "With bookbuilding, the underwriter coordinates the number of investors, recruiting more when initial interest is low and rewarding those that participate regularly. In auctions, by contrast, entry is left more to chance."²¹

Now, one may question why too many bidders would ever be a problem – one might have thought that the more bidders, the more likely it is that the issuer will achieve a high price and that the price will encapsulate all available information about the shares. Controlling allocations has advantages, however. It allows the issuer to reduce risk for both issuers and investors by ensuring that the participants in the offering will follow through on their trades. Further, as a gatekeeper of information with previous knowledge of the issuer, including the securities to be issued, the industry, and the market for such securities, the underwriter serves to ensure that information production is both voluminous and accurate.²²

19 Jagannathan & Sherman, *supra* note 13 at 3.

20 *Id.* at 3.

21 *Id.*

22 Ann E. Sherman, *Global Trends in IPO Methods: Book-Building vs. Auctions*, Working Paper, University of Notre Dame 8 (2004) ("Global Trends"). See also Thomas Chemmanur & Huanliang (Mark)

The foregoing discussion has assumed investment banks are not a “player” in the Dutch auction process and that the success of the offering depends solely on investor demand. However, investment banks can function as a cartel and influence the profitability of offerings with which they are not involved. They have an incentive to drive business away from offerings that do not utilize their services and that undermine their own business.²³ Thus, even if an issuer believes in the benefits of the Dutch auction (*i.e.*, its efficiency and fairness), it may face negative influence – a type of punishment – from investment banks that have been left out of the offering.

The Google IPO provides a good example of the effect of underwriter collusion in respect of deals to which they are excluded. Just prior to going public, Google reduced both the price and size of its offering. The IPO price plunged from an estimated \$121.50 to \$85 per share (which was the bottom of its revised range) while the number of shares dropped from about 25.7 million to 19.6 million shares. In the end, Google's total stock market value was reduced from more than \$30 billion to roughly \$23 billion.²⁴ As one observer stated, “If this had been a traditionally run IPO where investment banks were going to cash in, they

Liu, “How Should a Firm Go Public? A Dynamic Model of the Choice Between Fixed Price Offerings and Auctions in IPOs and Privatizations” Unpublished working paper (Boston College, Mass.) cited in Sherman, *Global Trends*.

²³ Jeremy Asay, *Dutch Auction IPO: Google Is Attempting a Moral High Ground on Wall Street with Its Recent IPO* (2005), at <<http://www.connect-utah.com/article.asp?r=732&iid=28&sid=1>>.

would have been supportive of the higher price, and you would have seen less criticism. They felt locked out of the process, so there was no incentive for them to move things along.”²⁵ In short, investment banks generally will oppose Dutch auctions because these transactions reduce their fees as well as their influence in the allocation process. This collusion surely undermines the argument that Dutch auctions lead to efficient pricing and fairer allocations.

Admittedly, the book-built method can lead to market inefficiencies also. When an issuer starts discussing a potential issue with many underwriters, they may start shorting the issuer’s stock to discern market depth and to place themselves in a position to comfortably bid a bought deal at a price which is discounted to the price their short selling has dropped the market. This allows them to cover their short position at a profit and virtually guarantees a short-term excess of demand over supply. While this result benefits the underwriters, it does not benefit the public, especially those that were “shorted down” into selling.

In summary, a company takes numerous considerations into account in planning the IPO. These are price, market following after the IPO, and fairness (discussed below).The willingness to underprice suggests that efficient price discovery can be less important than other objectives issuers have, such as creating demand

²⁴ David A Vise, “Google Ends auction for IPO shares” online at: <http://www.wpni.com/wp-dyn/articles/A10478-2004Aug18.html>

after the initial issuance. Price, and indeed the highest price, does not always win out, and, most importantly, the Dutch-auction approach does not appear to guarantee that the issuer will receive the highest price.

b. Fairness

Apart from efficiency in price discovery, a second ostensible feature of the Dutch auction is its fairness. Pricing is based on investor demand and is therefore divorced from any one particular institution or set of institutions. Since the pricing process is more objective, and underwriters are not leading the allocation process, the retail investor has an opportunity to participate in the offering. In the bookbuilt method, by contrast, the share allocation depends on the underwriter and the retail investor cannot typically participate directly. Thus, the Dutch auction is fairer in the sense that each individual has an equal chance to participate in the transaction, given adequate financial resources assuming her own financial resources.²⁶ We can call this “equality of opportunity.”

Some argue that because it excludes the retail investor, the bookbuilt process should be reformed.²⁷ Is a rule requiring equality of opportunity required? One

²⁵ Danny Sullivan, editor of Search Engine Watch, an online publication that monitors the search industry cited in Vise, *ibid*.

²⁶ This does not mean that all will end up with equal allocations, however. There is no equality of result here. For further discussion of the difference between equality of result and equality of opportunity in securities transactions, see Anita I. Anand, "Regulating Issuer Bids: The Case of the Dutch Auction" (2000) 45 *McGill Law Journal* 133-154.

²⁷ Ely R. Levy, *The Law and Economics of IPO Favoritism and Regulatory Spin*, 33 Sw. U. L. Rev. 185, 213 (2004): “The discriminatory allocation model currently in place can thus be perceived as unegalitarian and unfair to retail investors.” See also Cornelli *et al.*, *supra* note 15 at 1: “... while

way to analyze this question is to examine whether the offering market is a public good. A “public good” is a good that is difficult to produce for private profit because the market fails to account for its extensive beneficial externalities. By definition, a public good possesses two characteristics. First, it is non-rivalrous, meaning that once it has been produced, every person can derive a benefit from it without diminishing any one else’s enjoyment. Second, it is non-excludable, meaning that once the good has been created, access to it is difficult to prevent.²⁸

Thus, a main characteristic of a public good is that access to the good cannot be restricted. In the context of capital markets, all individuals, assuming the existence of their own financial resources, are in theory permitted to participate – that is, to purchase and sell securities. Capital markets exist, at least to some extent, because of an understanding among issuers, intermediaries, and investors that these parties will not abuse their respective functions. Without question, abuse does occur, and laws exist to prevent and deter this abuse. But in general, the interaction of a number of parties serves to make the market function for the benefit of all, particularly purchasers and sellers of securities. Access is not restricted, and the good does not diminish as more and more people participate.

bookbuilding allows the underwriter to observe how much institutional investors value the shares, it leaves out a large part of the market – the retail investors.” The authors add, “In the literature, the exclusion of retail investors from bookbuilding has typically been justified by arguing that retail investors are uninformed and it is optimal to restrict the participation in bookbuilding to the (informed) institutional investors.”

While anyone can in theory participate in an offering, different types of offerings permit different levels of participation in practice. In particular, the bookbuilding method for conducting these transactions tends to restrict investor access. Investment banks have control over the securities and their allocation, and the retail investor is not typically able to purchase shares in the offering. The Dutch auction, by contrast, does not discriminate among investors and therefore retains, at least in theory, the notion of the offering market as a public good. That is, any one investor can access the offering simply by following the procedure set forth in the registration statement, offering circular, or similar document.

Because the bookbuilt offering does not exhibit equality of opportunity, it tends to attract criticism from individuals who believe that all investors – retail and institutional – should have equal access to offerings. Critics claim that auctions are more “democratic” than the bookbuilding method because access to them is not limited or closed. The auction system does indeed appear to be fair. In particular, to the extent that the capital markets are a public good, then it would seem reasonable to have a system that gives all possible investors an equal opportunity to participate in an offering. In other words, investor A’s \$1 should be as good as investor B’s \$1. By analogy to housing purchases, one would be unlikely to accept the idea that only some people should be able to buy new

28 Wikipedia Encyclopedia, at <http://en.wikipedia.org/wiki/Public_good>.

houses on the real estate market because they are realtors, while the rest of the public does not have the requisite knowledge to participate in this market. Instead, one would think, as a matter of fairness, that if investor A has \$100,000 and investor B has \$100,000, they should both be able to bid on the house.

The Dutch auction does not prevent retail investors – or any other party, for that matter – from participating in a securities offering. Thus, it is more fair than the bookbuilding method in its ability to provide equality of opportunity to investors. But from a public policy perspective, another question arises: Should fairness, in the sense of equal opportunity, drive the public offering process?

In one sense, the offering market is already premised on an idea of fairness driven by equality concerns. Securities regulation attempts to ensure that market practices do not undermine investors' confidence. Surely, if every person does not have an opportunity to participate in a transaction on the same terms as everyone else, then investors will lose confidence in the capital markets, asking, "Why should I participate if the rules of the game differ as between players and I am at an unfair disadvantage?" From a market confidence standpoint, therefore, it likely matters to the retail investor that she has an opportunity to participate in a lucrative IPO and that the shares in an IPO are not allocated for "kickbacks" in

return.²⁹ A strong case can be made that market confidence declined once the practices of spinning and laddering on Wall Street came to light.

While it may be more fair to allow all investors, retail or not, to invest in public offerings, the results of doing so may be undesirable from a market efficiency standpoint. Retail investors can skew the market away from an efficient outcome when it comes to price determination. During the 1980s in Canada, for example, the size of the retail sector of traders shrank while, concurrently, the liquidity and price continuity of the Toronto Stock Exchange (TSX) improved over this period.³⁰ This trend is consistent with evidence from the United States, where Jones *et al.* have found that a higher volume of institutional trading is associated with lower bid/ask spreads, as well as lower market volatility.³¹ In addition, Boehmer *et al.* studied a broad cross-section of NYSE-listed stocks between 1983 and 2003, using measures of relative informational efficiency that are constructed from transaction data. They found that stocks with a higher fraction of

29 See *In Re eBay, Inc. Shareholders Litigation*, 2004 Del. Ch. Lexis 4 (Court of Chancery of Delaware) at para. 4. quoting the SEC: “the purpose of the interpretation is to protect the integrity of the public offering system by ensuring that members make bona fide public distribution of ‘hot issue’ securities and do not withhold such securities for their own benefit or use the securities to reward other persons who are in a position to direct future business to the members.”

30 Jeffrey G. MacIntosh, *The Role of Institutional And Retail Investors in Canadian Capital Markets*, 31 Osgoode Hall L. J. 371, 441 (1993).

31 J. Jones, K. Lehn, & J.H. Mulherin, *Institutional Ownership of Equity: Effects on Stock Market Liquidity and Corporate Long-Term Investments*, in A.W. Sametz, ed., *INSTITUTIONAL INVESTING: THE CHALLENGES AND RESPONSIBILITIES OF THE 21ST CENTURY* 115 (1991). See MacIntosh, *supra* note 28 at 441–442.

institutional ownership were priced more efficiently. Increases in actual institutional trading volume were also associated with greater efficiency.³²

Further, analysts studying investor behavior have demonstrated that the investment patterns of retail investors are more volatile because investment decisions are more likely to be affected by the herd mentality.³³ Retail investors also place disproportionate weight on recent news stories at the expense of information not readily available in the press.³⁴ Retail investors have also been termed “rationally apathetic”: they do not have an interest in reading disclosure documents and becoming informed because the costs of doing so outweigh the benefits.³⁵

Given these characteristics of retail behavior, it may not be unwise to support an offering process in which retail investors can be excluded if the result is less information asymmetry and therefore a more efficient deployment of capital. As

32 Ekkehart Boehmer, Eric Kelley, & Christo A. Pirinsky, *Institutional Investors and the Informational Efficiency of Prices* (April 20, 2005), at <<http://ssrn.com/abstract=687110>> at 29.

33 Donald C. Langevoort, *Selling Hope, Selling Risk: Some Lessons for Law from Behavioral Economics About Stockbrokers and Sophisticated Customers*, 84 Cal. L. Rev. 627 (1996); Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future*, 51 Duke L.J. 1397 (2001); Stephen J. Choi & Adam C. Pritchard, *Behavioral Economics and the SEC*, 56 Stan. L. Rev. 1 (2003).

34 See Langevoort, *ibid.* at 635.

35 See F.H. Easterbrook & D.R. Fischel, *Voting in Corporate Law*, 26 J.L. & Econ. 395, 402 (1983); M. Lipton, *Corporate Governance in the Age of Finance Corporatism*, 136 U.Pa.L.Rev. 1, 66–7 (1987); G.W. Dent, Jr., *Toward Unifying Ownership and Control in the Public Corporation*, Wis.L.Rev. 881 (1989); see also B.S. Black, *Shareholder Passivity Reexamined*, 89 Mich.L.Rev. 520, 567–70 (1990); S.M. Bainbridge, *Independence Directors and the ALI Corporate Governance Project*, 61 G.W.L.R. 1034, 1055 (1993); and J. Garrido & A. Rojo, *Institutional Investors and Corporate Governance: Solution or Problem?* in K. Hopt & E. Wymeersch (eds.), *CAPITAL MARKETS AND COMPANY LAW* 427 (2002).

Boehmer *et al.* state, “the informational efficiency of prices is a valuable public good, because all market participants benefit from more efficient prices.”³⁶ In fact, the public good is the capital market itself, since it exhibits the two characteristics of a public good isolated above: it is, in theory, both non-rivalrous and non-exclusive. It is true, however, that a more efficient market is more valuable, since the benefits for all who participate are greater than they would be in an inefficient market.

What does this analysis tell us about Dutch auctions? There are reasons to question conventional arguments in favor of these transactions. The Dutch auction IPO is not necessarily more efficient in terms of price discovery, and, indeed, underpricing still appears to occur when this mechanism is used. Further, even if the Dutch auction is more fair than the bookbuilt process in terms of allocating securities (what we have termed “equality of opportunity” to participate in the transaction), the Dutch auction can lead to less capital market efficiency overall and can therefore be questioned as a basis for promoting this type of offering.

3. Strengths of the Bookbuilt Mechanism

In the previous section, I raised doubts about the Dutch auction as a financing method but did not present an argument in favor of the bookbuilt offering. In

³⁶ Boehmer *et al.*, *supra* note 32 at 29. See also Nicholas L Georgakopoulos, *Insider Trading as a Transactional Cost: A Market Microstructure Justification and Optimization of Insider Trading*

this section I turn to such an argument, examining relevant empirical evidence that highlights the popularity of the bookbuilt offering and providing cogent explanations for this popularity.

In the United States and around the world, the bookbuilding procedure for selling IPOs to investors is more popular than alternatives such as the Dutch auction or modified auction. In a study that covers 47 countries, Sherman has found that in all countries in which the bookbuilding mechanism has been introduced, pre-existing auction systems have decreased in popularity or disappeared altogether.³⁷ For instance, in France, where auctions were once prevalent, they have disappeared and the bookbuilding method is now prevalent.³⁸ In Japan, too, bookbuilding has replaced auctions.³⁹

This popularity may be surprising, since bookbuilding has been considered the most costly IPO mechanism available in terms of direct fees and initial underpricing.⁴⁰ In the United States, between 1980 and 2001, IPOs were

Regulation, 26 Conn. L. Rev. 1, 45 (1993-1994).

³⁷ Sherman, “Global Trends”, *supra* note 22, at 5, states, “IPO auctions were tried in Italy, the Netherlands, Portugal, Sweden, Switzerland, and the UK in the 1980s and in Argentina, Malaysia, Singapore, Taiwan, and Turkey in the 1990s, but they were abandoned years before book building became popular”.

³⁸ *Id.*

³⁹ K. Kutsuna & R. Smith, *Why Does Book Building Drive Out Auction Methods of IPO Issuance? Evidence from Japan*, 17 *Review of Financial Studies* 1129 (2005).

⁴⁰ Derrien & Womack, *supra* note 2, providing empirical evidence on the French IPO market, where both auctions and book-building are used, show that auctioned IPOs “leave less money on the table” than bookbuilt IPOs.

underpriced by 22% on average.⁴¹ This implies that over \$100 billion was left on the table.⁴² The underpricing of these securities creates the potential for abuse in allocation (*e.g.*, spinning and laddering). Numerous underwriting scandals have come to light in the United States since the market crash of 2000.⁴³

The specific question is this: If auctions enable issuers to raise more or equivalent cash at lower cost, why do issuers appear to prefer the bookbuilding process? Jagannathan and Sherman argue that some money must be left on the table to encourage investors to participate in the process of price discovery, and that the bookbuilding process is well designed to accomplish price discovery cost-effectively. Underpricing and differential allocation of shares are justified because they compensate those investors who make the greatest contribution to price discovery by setting an offering price below fair value and by allocating more shares to those who provided valuable information.⁴⁴

Others contend that corporate issuers and investment banks are in a *quid pro quo* relationship that extends beyond obvious direct costs. Issuers are willing to pay the higher direct and indirect costs of the bookbuilding process in exchange for increased and more favorable research coverage, and thus choose the

41 Jay R. Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 *The Journal of Finance* 1795 at Table 1 (2002), cited in Jagannathan & Sherman, *supra* note 13 at 2.

42 Jagannathan & Sherman, *supra* note 13 at 2.

bookbuilding mechanism rather than an auction.⁴⁵ In support of this theory, Degeorge *et al.* have presented empirical evidence from France's IPO market that underwriters employing the bookbuilding process implicitly committed to providing more favorable coverage to the companies they took public in the aftermarket. Analysts affiliated with the lead underwriter of the offering issued more (and more favorable) recommendations for recent bookbuilt IPOs than for auctioned offerings. These analysts also provided positive recommendations, following poor stock-market performance, to recent bookbuilt IPOs; but this positive feedback did not happen for auctioned offerings.⁴⁶

These studies indicate that issuers are willing to use a more costly method in order to receive increased and more positive analyst coverage. Anand and Johnson probed reasons for the infrequency of direct public offerings (DPOs, *i.e.*, offerings conducted without an underwriter), of which the Dutch auction is one variety.⁴⁷ We asked whether this infrequency stems from a belief among issuers that they cannot duplicate the functions of the underwriter. Our data suggest that firms consider underwriters to be crucial in the offering process, regardless of the potential cost savings from dispensing with the underwriter in the transaction.

43 François Degeorge *et al.*, *Quid Pro Quo in IPOs: Why Book-Building Is Dominating Auctions* (January 2005), ECGI – Finance Working Paper No. 65/2005; FEEM Working Paper No. 150.04; RICAFA Working Paper No. 011 (2005), at <<http://ssrn.com/abstract=582963>> at 1.

44 Jagannathan and Sherman, *supra* note 13 at 2.

45 *Id.* at 2.

We first held focus groups and then sent surveys sent to the approximately 1,300 listed companies on the Toronto Stock Exchange.⁴⁸ The focus groups suggested that issuers' and investors' a lack of familiarity with DPOs, and their consequent unwillingness to undertake them, was a barrier to the proliferation of these transactions. The results of the survey indicated a similar reluctance on the part of both groups. The survey was pre-tested on a subset of focus group participants, and the final version was then sent to a contact person (usually the CFO) at each listed company. The survey asked participants to indicate their relative receptiveness to the use of DPOs for equity, debt, and income trust securities.⁴⁹ Participants were then asked to indicate their level of agreement or disagreement on a number of potential explanatory factors and to provide some firm-specific demographic information.⁵⁰

⁴⁶ *Id.* at 2.

⁴⁷ Anand & Johnson, *supra* note 7.

⁴⁸ *Id.*

⁴⁹ Income trust securities are hybrid securities whereby the holders get access on a (mostly) tax-free basis to the operating income of the underlying company. They have dominated the IPO market in Canada, constituting 94% of all issues in 2002. They are gaining popularity in the United States in the form of income deposit securities.

⁵⁰ In spite of four mailings, the survey had a disappointing response: only 60 valid responses, representing a response rate of about 5%. This low response rate could be interpreted as an indication of the general level of interest in the market for DPOs, but more likely it was a function of lack of time at the senior corporate level to complete the survey. It does raise the possibility of selection bias: those executives who did reply are presumably more knowledgeable about, and possibly more interested in, DPOs as an alternative financing medium. The implication of this selection bias is that we should treat our results with caution, as they may represent the sentiment of a subset of the market, not the entire market. However, the response rate is not out of line with other surveys of corporate executives (*e.g.*, John Graham & Campbell Harvey, *The Theory and Practice of Corporate Finance: Evidence from the Field*, 60 *Journal of Financial Economics* 187 (2001)). The number of responses did provide enough data to conduct statistically meaningful empirical tests.

The most uniform explanatory variable was the perception that investment banking experience cannot be replaced. The second most significant determinant was the degree of unfamiliarity (and hence discomfort) with DPOs. This is evident in the recurring significance of the idea that more firms, and more well-known firms, need to do DPOs before the practice becomes widely accepted. The other variables that seemed to have some explanatory power (the perception that the Internet is unsafe, the absence of a well-defined rule of law, and the role of a loyal customer base) are also consistent with the unfamiliarity hypothesis. The result is that when firms are faced with an uncertain environment, they tend to rely on the traditional approach to raising capital. That is, they use an underwriter to complete the offering.

Our research indicates that underwriters are considered integral to the offering process for a variety of reasons, including the role that the underwriter plays in lending credibility to the offering. However, underwriters likely serve a less important function in certain circumstances, such as when the issuer is seasoned, the investors are sophisticated, or the offering consists of debt rather than equity securities. The presence of each of these factors can result in lower information costs, thereby increasing the potential for an efficient DPO.⁵¹ For example, consider a DPO of debt securities or preferred shares conducted by a seasoned,

⁵¹ Anita Anand, "The Efficiency of Direct Public Offerings" (2003) 7:3 *Journal of Small and Emerging Business Law* 1.

rated issuer. This transaction is likely to be efficient since the interest rate/dividend yield for the issuer is a well-informed, non-underwriter driven market.

In sum, there is a strong argument to be made that bookbuilt IPOs are widely preferred, at least among issuers in North America. Established underwriters have a comparative advantage in persuading investors to purchase the IPO. In addition, there is a belief among both issuers and investors that underwriters are the first parties in the market to invest in information about a new security. They can therefore be trusted as a third party to lend credibility to the issuer and the securities to be issued. There is also a perceived need for the services that underwriters provide: underwriters are a market mechanism that avoids the inherent problems with information as a public good (such as unverifiability).

This argument casts doubt on the conventional wisdom that Dutch auctions are preferable to bookbuilt methods because they are both more efficient and more fair. While it may be too soon to evaluate the long-term potential of Dutch auction IPOs in North American capital markets, the question that does arise is whether the current system should be reformed because of fairness or other concerns. The key issue is whether an *ex ante* legal rule requiring fairness in securities offerings is necessary or whether this issue should be resolved by market forces alone.

4. Policy Prescriptions

I have questioned the merits of the Dutch auction as a means of offering securities. First, I argued from a theoretical perspective that the Dutch auction does not live up to its reputation in terms of either price discovery or fairness. Second, I discussed reasons for the popularity and persistence of the bookbuilt method. Chief among these reasons are the desire for analyst coverage and the credibility that the underwriter extends to the offering. In this section, I examine what role, if any, law should play in promoting and allowing certain types of offerings over others.

The starting point for the discussion is my contention in Part 2 that the market for public offerings can be understood to be a “public good.” A public good is by definition one that exists because of the common efforts of many as opposed to one individual and one that does not exclude any one individual from partaking in its benefits. Capital markets fall within this understanding of the term “public good.” Capital markets can exist only because of the participation of many – issuers, investors, market intermediaries – and access to this good is not restricted. That is, investors of all sorts can participate in the benefits that the good offers, as long as they have the financial means to do so.

If we accept this argument, then a *prima facie* case can be made in favor of reforms that ensure fairness in allocating securities in a public offering. In particular, there are fairness concerns with the bookbuilding system: it does not allow all investors to participate, since it is dominated by institutions. It also has given rise to abusive practices such as spinning and laddering.

Corporate law currently has rules in place to deal with certain types of unfairness. First and foremost is the law of fiduciary duty⁵² and, in particular, the doctrine of corporate opportunity, which can be invoked when a corporate officer or director diverts an opportunity that belongs to the corporation to him- or herself. In *eBay*, the plaintiffs alleged that the investment bank allocated eBay shares to officers and directors of eBay to demonstrate appreciation for past business and to provide an incentive to these insiders to use the bank's services in the future. The plaintiffs further alleged that the eBay insiders resold shares purchased in the IPO for millions of dollars in profit. The Court held that the directors who received shares in the IPOs could not use the defense that the corporate opportunity was too risky because the corporation was never given an opportunity to turn down purchases of shares in the IPO.⁵³

52 See Therese Maynard, *Spinning in a Hot IP – Breach of Fiduciary Duty or Business as Usual?* 43 Wm. and Mary L. Rev. 2023 (2002).

53 *eBay*, *supra* note 29 at paras. 3 –4.

Apart from obviously unfair practices, should regulation compel issuers to undertake certain types of offerings rather than others in order to make them more equal? Under a strict free-market analysis, regulators should not mandate any one particular form of offering but should allow the most efficient offering mechanism to emerge. On this view, it seems unnecessary to require an auction system, or any other mechanism that aims to ensure retail participation.⁵⁴

The most efficient offering mechanism will surely vary by issuer. Google's Dutch auction was successful because of its world-renowned product. In addition, it used its product (the Internet) to take bids and had a highly profitable history. But this approach would not serve other issuers who are less well known and whose product is not Internet based. Thus, from an efficiency perspective, it may be unwise for regulators to promote any particular offering method. If regulation favors the Dutch auction, or any other mechanism, over the bookbuilding method, the consequence may be lower efficiency overall, which will benefit neither issuers nor investors.⁵⁵ This means that traditional intermediaries remain an important player in the valuation process. We should not seek to abandon them via new regulations that downplay their role in capital markets.

54 The National Association of Securities Dealers (NASD) requested comments on whether underwriters should be required to use an auction system to collect indications of interest.

55 As the U.S. Securities Industry Advisory Committee stated, "the market, and not regulators, should determine whether book-building, a Dutch auction or another method is desirable for a particular

This argument stems primarily from efficiency concerns. The bookbuilding method contributes to market efficiency by allowing informed investors to participate in public offerings. An efficient market is a public good, since all market participants benefit from advantages such as liquidity and efficient price discovery.⁵⁶ But this does not mean there is no validity in the argument that the bookbuilding process is unfair to retail investors. If we agree that bookbuilt IPOs prevent equality of access and that this type of equality is a worthwhile objective in public offerings, we should at least examine whether the retail investor can be accommodated within the current system. From a policy standpoint, is it possible to provide equality of access without dispensing with the bookbuilding method altogether?

One suggestion has been to implement a rule that compels retail investors to qualify for each offering by passing a multiple-choice examination. The exam would deal with the company's plans, risk factors, and use of proceeds based on information contained in the prospectus. Jagannathan and Sherman report that this procedure was used in Europe in the 1990s by a German investment bank.⁵⁷ The authors are correct to point out that this process would discourage naïve investors seeking to free-ride on the efforts of more informed investors. However, the difficulty with this suggestion is one of efficiency. Issuers

IPO.” See letter from the Securities Industry Association to the NASD (January 23, 2004) [on file with author].

56 See Boehmer *et al.*, *supra* note 32 at 50.

completing an IPO or public offering need to get to market during a certain, usually small, window in order to benefit from perceived demand and other exogenous factors (*e.g.*, political stability). Forcing issuers to develop and administer a test for retail holders endangers this process and the very idea of capitalizing on windows of opportunity.

Another suggestion is to implement a rule compelling a certain percentage of IPOs whose total value exceeds a certain threshold to be reserved for retail investors. Jagannathan and Sherman report that “nearly all countries outside the US open up their IPOs to the general population.”⁵⁸ In many of these countries, the law requires that a tranche of each offering be reserved for the public. Retail investors are permitted to place orders in a separate tranche, and they all have an equal opportunity to obtain shares. The orders are filled *pro rata* where the tranche is oversubscribed. In some cases, however, the prices are set by institutions that are professional investors.⁵⁹

In the Philippines, for example, issuers are required to sell 10% of the shares in their IPO directly to the public.⁶⁰ In Chile, regulations require an auction tranche; the resulting hybrid of the bookbuilding method can be used to ensure retail

57 Jagannathan & Sherman, *supra* note 13 at 72.

58 *Id.* at 5.

59 *Id.* at 5.

participation. In Indonesia, a hybrid allocation method is also used under which a maximum of 40% of the securities being offered can be allocated to institutions and the rest must be available to retail investors.⁶¹ In Spain, the distribution of an IPO among retail, local, institutional, and foreign investors is set forth in the prospectus, which is filed prior to formal applications for IPO shares from any investor.⁶² In Singapore, orders for shares in IPOs can be submitted through automated teller machines (ATMs), and, indeed, half of Singapore's population participated in the 1993 Singapore Telecom IPO.⁶³

The practices of these countries indicate that it is possible to accommodate the retail investor without dispensing with the bookbuilding process altogether. However, a first difficulty with hybrid transactions is that timing issues can arise because the offer price must be set far in advance for the retail tranche.⁶⁴ This prevents price from being based on demand if the remaining tranche is auction based. It also prevents an unfettered bookbuilding process from occurring. Second, although the hybrid offering may enhance equality of access, it implies that institutions and retail shareholders compete in offerings. Practically

60 See Matthew Fletcher & Cesar Bacani, *Riding the IPO Wave: How Small Investors Can Profit from Initial Public Offerings*, ASIaweek magazine at <<http://www.asiaweek.com/asiaweek/96/1122/cs3.html>>.

61 Sherman, *supra* note 22 at 7.

62 Vicente Pons-Sanz, *Who Benefits from IPO Underpricing? Evidence from Hybrid Bookbuilding Offerings*, Working Paper Series No. 428, ECB-CFS Research Network on Capital Markets and Financial Integration in Europe (2005), available at <<http://www.ecb.int>> or <http://ssrn.com/abstract_id=634023> at 5–6.

63 Jagannathan & Sherman, *supra* note 13 at 71.

64 Bhagwan Chowdhry & Ann Sherman, *International Differences in Oversubscription and Underpricing of Initial Public Offerings*, 2 Journal of Corporate Finance 259 (1996).

speaking, in Canada and the United States at least, this type of competition does not seem to occur. In any given offering, retail shareholders may not be keen to invest and the offering may remain undersold, especially if there is no intermediary to market it. The hybrid offering or auction is more risky for the issuer because there is no guaranteed stable of investors.

Jagannathan and Sherman suggest that finding investors for a hybrid offering will not be a barrier to these transactions, arguing that “What Americans may find, however, is that IPO shares are hard to get even when they are open to all retail investors on an ‘equal’ basis, since there simply aren’t enough IPO shares for everyone in the US to get a reasonable allocation. Shares will thus have to be rationed in some way....”⁶⁵ This prediction seems optimistic and certainly flies in the face of literature relating to rational shareholder apathy.⁶⁶ In Canada, at least, we have not heard cries for a more open IPO process to the same extent that we have heard of the need for better corporate governance practices and a national securities commission, for example.

Perhaps the basis for this observation is that in capital markets where a majority of retail shareholders invest through mutual funds, ensuring direct access to public offerings for the retail shareholder is unnecessary. Rather than invest

65 Jagannathan & Sherman, *supra* note 13 at 6.

66 See *supra* note 35.

directly in IPOs, retail investors tend to invest in mutual funds. In Canada, the mutual fund industry is reported to be the fastest-growing segment of the financial services sector. During the 1990s, assets under management grew from \$25 billion in December 1990 to \$426 billion by December 2001, an increase of 1,700 per cent. These assets were managed in approximately 1,800 different mutual funds and held in over 50 million unit-holder accounts.⁶⁷ By the end of 2004, mutual fund investments totaled over \$522 billion in more than 1,900 different funds, accounting for 27% of the Canadian wealth market.⁶⁸ In the United States, mutual-fund investments account for 29% of the wealth market.⁶⁹

Shareholders clearly can access public equity, and are doing so at increasing rates, through the mutual-fund industry. More significantly, investor activist groups have not raised investor protection issues in the context of the flurry of offering activity that has occurred in Canada over the past five years or so. Given the way in which the offering market, especially for income trusts, has thrived in Canada, it is difficult to argue that market confidence is lacking in this aspect of

67 Department of Finance of the Government of Canada, *Canada's Mutual Fund Agency* (March 2002), at <http://www.fin.gc.ca/toce/2002/cmfi_e.html>.

68 Investor Economics, *2005 Household Balance Sheet Report* (December 31, 2004), at <<http://www.investoreconomics.com>>. This report defines the term "wealth market" as "all investable financial assets held by Canadians; Includes Deposits – including Fixed Term Savings, GIC's GIA's) Funds – Long and Short Term funds; Mutual funds; segregated funds and Group Segregated Funds; Fixed Income Instruments – Canada Savings and Government Bonds; Mortgage Backed securities; Equity – Common and Preferred Shares; Income Trusts and hedged funds – DBPP's are not included in these figures."

69 *Id.*

Canadian capital markets.⁷⁰ Admittedly, one could argue that the reason retail investors use mutual funds is that Dutch auctions have never been widely – deployed, so the investing public may not have a choice to invest in these vehicles. They turn to other avenues, such as mutual funds and hedge funds, to diversify their equity portfolios. But why, then, are they not clamoring for reform? Are they too apathetic?

Although the bookbuilding process has the potential to exclude retail investors, the IPO process is not in need of reform. Reform of capital market regulation should occur only where the benefits would outweigh the cost of the additional regulation. In the case of regulation to ensure market access for retail investors in offerings, this test would likely not be met. The costs of the regulation would be obvious, as issuers would not be able to sell their securities to the bidders they prefer to deal with. Markets would be less efficient, since uninformed investors are purchasing the securities under the offering. Furthermore, the benefits of an equality-of-access regime are not definite, since it does not appear that retail investors, in Canada at least, would be any more advantaged than they are at present.

70 Over the past seven years the capital markets saw more an increase of more than 700% in income trust investments through IPOs and trust conversions. As of December 31, 1997, income trusts accounted for \$15.2 billion worth of market capitalization in 51 trusts. As of December 31, 2004, this had grown to over \$118 billion in 170 trusts. Dawn Jia & Yin Luo, *Profiting from Income Trust IPO's* (January 24, 2005), at <<http://www.cibcwm.com/research/trustipo50124>> at 2. [unable to find current link]

Again, we should draw a distinction between the Dutch auction IPO and the issuance of securities by a seasoned and widely-traded issuer. While the Dutch auction likely does not enhance efficiency in the IPO market, it may do so for large, mature companies that are already public is issuing their shares directly, over the Internet for example. For them, the markets are already pricing their publicly traded stock and their issue sizes are relatively close to their shorter term trading volumes. A major buyer in these transactions will likely be mutual funds and hedge funds that are not dependent upon investment bank analysis (which has been shown to be biased towards their underwriting clients). As funds and the general public become used to participating in this market and using alternative research sources, the size and type of issuer able to use the market will come down.

5. *Conclusions*

I have argued here that the bookbuilding method of offering securities is superior to the Dutch-auction IPO. While the Dutch auction may seem to lead to efficient price discovery based on investor demand, recent transactions suggest that price discovery is not always accurate and that, indeed, underpricing occurs even in the Dutch auction. Furthermore, while capital markets can be seen to be a public good, the need for additional law over and above fiduciary duty examinations and the corporate opportunity doctrine is not apparent. In the analysis, it is important to take into account the practicalities of the capital

markets: retail investors in Canada and, to a lesser extent, the United States hold the majority of their investments in mutual funds and, therefore, are not likely to chase IPOs.