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What Google Can't Tell Us About Internet Auctions (And What It Can)

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I. Introduction

No initial public offering in the history of the United States capital markets has been as intensely discussed as the August 2004 offering of Class A Common Stock of Google, Inc. From the announcement of the IPO itself to the details of its innovative Internet auction to the post-IPO share price, the investing world has been continuously discussing Google for almost a year. One aspect of Google's IPO that received much attention before the offering was the fact that Google chose an online auction process as the mechanism to distribute its original IPO shares. In keeping with Google's nonconformist image, the founders of Google chose an IPO mechanism that is used only once or twice a year in the U.S. Many detractors of the traditional bookbuilding mechanism declared that the Google auction foreshadowed an upheaval in the cliquish investment banking industry. However, after the offering had taken place and the share price was on the rise, public attention gradually turned to the future of Google, closing the door on discussions of the auction process. Although Google's auction was predicted to be the beginning of a trend, if anything, the auction process was blamed for low investor demand in the weeks leading up to the offering and a last-minute slash in the price range. In addition, in the year since the Google auction, only two other issuers have launched an online IPO.

As observers of the intersection of the Internet and the securities markets, we are left to wonder whether the Google auction was a harbinger of change, a meaningless electronic blip, or even worse, a marketing event for the public relations-conscious issuer.[1] This article analyzes this historic IPO and explores what importance the Google IPO has for the campaign for online IPO auctions. Unfortunately, because Google was a unique issuer in many positive and negative respects, its offering cannot be used to herald an immediate sea change in the bookbuilding IPO market. However, Google's auction will only assist other issuers in negotiating with underwriters for alternative offering mechanisms.

II. Background

A. *The Initial Public Offering Machine*

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[1] *See generally* Victor Fleischer, *Brand New Deal: The Google IPO*, Law & Economics Working Paper No. ____ (2005).

During the first day of trading in an initial public offering, most IPO shares experience a price increase from the offering price to the closing price for the day.[2] During the period 1980-2001, the average IPO share price increased during the first dayby 18.8 percent.[3] This first-day "pop" will also be pronounced during "hot" IPO markets, such as the market that existed during the technology boom, specifically in 1999 and the first half of 2000 (the "1999-2000 Boom").[4] During this period, the average first-day increase was 77%.[5] Technology issuers had even more dramatic first-day share price increases, with one-third of those issuers seeing the share price double in the first day.[6] However, in 2001, after the bursting of the technology bubble, the average first-day increase declined to 14%, marking the beginning of a cold IPO market.[7] Even in more lethargic market environments, the investment bank that determines the offering price seems to fix that price at a substantial discount from the price the market will bear.

The issuing company sells all its shares at the offering price, so the issuer does not profit from any share price increase, although insiders who sell shares in the aftermarket may be able to sell at the higher price. Primarily, persons that capitalize on the spread between the offering price and the market price are the persons that were able to buy IPO shares at the original offering price. In almost all IPOs conducted in the United States, the vast majority, almost 80 percent, of original IPO shares are pre-allocated by the underwriters of the offering.[8] The recipients are usually institutional investors known to the underwriters and regular customers of the underwriters. In fact,

[2] *See generally* Christine Hurt, *Moral Hazard and the Initial Public Offering*, 26 CARDOZO L. REV. 711, 714-16 (2005) (describing the life cycle of an IPO share).

[3] Jay Ritter & Ivo Welch, *A Review of IPO Activity, Pricing, and Allocations*, 57 J. FIN. 1795 (2002).

[4] Francois Derrien & Kent L. Womack, *Auctions vs. Bookbuilding and the Control of Underpricing in Hot IPO Markets*, 16 J. FIN. STUDS. 31, 44 (2003).

[5] Melanie Warner, *Friends and Family, Sycamore Gave Lots of "Directed Shares" to a Key Customer*, FORTUNE, Mar. 20, 2000, at 102.

[6] *See id.*

[7] Alexander P. Ljungqvist et al., *Hot Markets, Investor Sentiment, and IPO Pricing* (Nov. 6, 2003), *available at* http://ssrn.com/abstract=282293 (last accessed Oct. 3, 2004), at 10.

[8] Betrice Bohemer et al., *Do Institutions Receive Favorable Allocations in IPOs with Better Long Run Returns?* 14 (Mar. 29, 2004), available at http://ssrn.com/abstract=350820 (studying a sample of IPOs and determining that 79% of all original IPO shares in the sample were allocated before the IPO by the underwriter).

institutional investors receive approximately 75% of original IPO shares in the average offering.[9] A much smaller number of original IPO shares are then distributed by the issuers to employees, relatives, friends, and business partners as part of "friends and family" programs.[10] Between these two allocations, no more than 20% of an offering will be available for sale at the opening of trading. For retail investors who want to invest in the issuer, buying shares from original recipients at a higher price in the aftermarket is the only route to ownership. Roughly, institutional investors receive IPO shares at the offering price, then sell to retail investors in the next few days at the higher price, pocketing the difference.[11]

1. Bookbuilding Method

The bookbuilding method gives the lead underwriter all of the control, all of the time. The underwriter controls how the offering is marketed, how the offering is priced, who receives the IPO shares, and when those recipients may sell their shares in the secondary market. The underwriter solicits "indications of interest"[12] from investors during the road shows, which take place after the company has filed its registration statement, but before the statement has been declared "effective" by the SEC. Not surprisingly, the only investors usually invited to road shows are large, institutional investors and extremely wealthy individuals.[13] From these indications of interest, the underwriter not only sets the price for the original IPO shares but also determines which road show attendee will receive shares at the original IPO price and how many. As noted above, the underwriter allocates almost all of the IPO shares available for purchase before the shares are sold on the open market. Additionally, the underwriters employ certain tactics to encourage original recipients not to sell their

[9] Reena Aggarwal et al., *Institutional Allocations in Initial Public Offerings: Empirical Evidence*, at 2 (forthcoming 2000).

[10] Renee Deger, *IPO Directed Share Plans Pose Risks*, NAT'L L.J., Sept. 13, 1999, at B5 (describing how before the 1999-2000 Boom, directed share plans generally accounted for 10 percent or less of a total offering but grew during this time period).

[11] *See id.* at 33 (stating that 92 percent of shares sold by institutional investors on the first day of trading are bought by retail investors).

[12] *See* Francesca Cornelli & David Goldreich, *Bookbuilding & Strategic Allocation*, 56 J. Fin. 2337, 2337 (2001).

[13] *See* Adam Lashinsky, *It's Time to Open Up the Road Show: What the SEC Doesn't Want You to Know*, FORTUNE, Nov. 8, 1999, at 338; The Regulation of Securities Offerings, Exchange Act Release No. 7606A, 63 FED. REG. 67174, 67214 (Dec. 4, 1998) (acknowledging that investment banks generally invite only selected broker-dealers and large investors to road shows).

shares within the first few days ("flip"), but instead to hold on to those shares.[14] Therefore, the number of shares that are available to be purchased even in the first few days is very small. This fact, added to any hype for the offering, creates a situation in which demand exceeds the very small supply. This situation ensures that when retail investors do begin buying shares from original allocatees the first few days of the offering, the price will increase, leading to much-publicized first-day pops.

The bookbuilding process, complete with underpricing and pre-allocations of shares to customers, does not fun afoul of any state or federal laws, including securities laws and NASD rules. However, scandals have shown that this inherently flawed process also creates possibilities for abuse. During the 1999-2000 Boom, underwriters used the ability to price IPO shares below the "indications of interest" to then "spin" these shares to potential clients or valued customers. These shares had a built-in gain that could be realized by selling the shares in the first few days at the higher market price. This ability to allocate profit became very powerful and led many investment banks to abuse this ability.[15] The most extreme abuses occurred when investment banks, even the ones with household names, allocated shares to investors in return for excessive brokerage fees.[16] Charging excessive brokerage fees was a violation of NASD rules, and many brokerage firms have

[14] *See* Royce de R. Barondes, *Adequacy of Disclosure of Restrictions on Flipping IPO Securities*, 74 TUL. L. REV. 883, 885 (2000) (detailing underwriters' practices of penalizing broker-dealers who flip securities and the resulting pressure on broker-dealers to keep their customers from flipping).

[15] The SEC named ten major investment banks in a lawsuit primarily regarding analysts touting the stock of issuers who were clients of the analysts' own investment banks. *See* SEC v. Bear, Stearns & Co., et al., 03 Civ. 2937 (S.D.N.Y. 2004). In the complaint, both Credit Suisse First Boston and Solomon Smith Barney were charged with spinning IPO shares in "hot" IPO offerings. In the global settlement of these claims, CSFB and Solomon neither admitted nor denied these claims. All ten investment banks entered into a Voluntary Initiative Regarding Allocations of Securities in "Hot" Initial Public Offerings to Corporate Executives and Directors, agreeing to "place restrictions on the ability of investment banking firms to allocate securities in 'hot' IPOs," but only to executives and directors of public companies. *See* Voluntary Initiative Regarding Allocations of Securities in "Hot" Public Offerings to Corporate Executives and Directors, *at* http://www.sec.gov/news/press/globalvolinit.htm. The terms of the Voluntary Initiative rendered its expiration upon the passage of new Rule 2790, which is actually more lax on the subject than the Voluntary Initiative. *See* NASD Rule 2790.

[16] For example, the NASD announced in May 2004 that it had fined Bear Stearns & Co., Inc., Morgan Stanley & Co., and others, for churning excessive fees on the day of the IPO for the accounts of allocatees. *See Press Release, NASD Charges Invemed Associates with Sharing in Customers' Profits from Hot IPOs* (April 25, 2003), *available at* http://www.nasdr.com/news/pr2003/release_03_014.html). For example, a customer may be granted an opportunity to buy hot IPO shares on a certain day, but during that day, the broker will buy and sell a liquid security for the same customer and charge a fee of $100,000 instead of a $3000 fee.

been investigated and penalized for this type of abuse.[17]

In addition, investment bankers engaged in the practice of allocating shares to officers of corporations in return for promises of future lucrative investment banking business.[18] Since the 1999-2000 Boom, the NASD has proposed a new rule, Rule 2712, which would prohibit investment bankers from allocating IPO shares to executives in a quid pro quo transaction.[19] This type of allocation abuse, unlike allocations matched with the generation of excessive fees, is much harder to prove without evidence that an officer of a corporation would not have chosen a particular investment bank for an offering had a broker at that investment bank not allowed that officer to participate in a lucrative IPO months before or after.[20] Unfortunately, this proposed rule has been open for comment for three years, so the probability that it will be accepted is small.

[17] *See* Press Release, *NASD Charges Invemed Associates with Sharing in Customers' Profits from Hot IPOs* (April 15, 2003), available at http://www.nasdr.com/news/pr2003/release_03_014.html) (describing how customers who received allocations of original IPO shares in hot issues would then enter into a wash trade in a different liquid security, paying the brokerage firm commissions up to six times the normal fee); *see also* Press Release, *Thomas Weisel Partners to Pay $1.75 Million to Settle NASD Charges of IPO, E-Mail Retention Violations* (Mar. 30, 2005), available at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013698 (determining that Thomas Weisel Partners receive excessively high commissions ($1 per share compared to the normal six cents per share) on highly liquid trades within 24 hours of allocating hot IPO shares to the same customers during 1999-2000).

Cf. Press Release, Morgan Stanley to Pay $2.7 Million for IPO Lock-Up Violations (June 9, 2000) (fining Morgan Stanley for accepting IPO shares as fees, then violating NASD rules by selling shares for a profit before the expiration of one year, resulting in an "excessive fee").

[18] Probably one of the more famous examples after Credit Suisse's Frank Quattrone's trial was Mr. Quattrone's spinning of Corvis IPO shares to Michael Dell of Dell Inc. in an effort to gain investment banking business from that company. During trial, email correspondence was entered into evidence in which Mr. Dell asked for IPO shares: "We would like 250,000 shares of Corvis. I know there have been efforts on both sides to build the relationship [between Dell Inc. and CSFB], and an offering like this would certainly help."

[19] *See* National Association of Securities Dealers, Notice to Members 02-55 (Aug. 2002) (requesting comment on Proposed New Rule 2712 (IPO Allocations and Distributions)).

[20] *Self-Regulatory Organizations: Notice of Filing of Proposed Rule Changes by the New York Stock Exchange National Association of Securities Dealers Relating to the Prohibition of Certain Abuses in the Allocation and Distribution of Shares in Initial Public Offerings*, 69 FED. REG. 77804 (Dec. 28, 2004) (giving the text of the second amendment to the proposed rule, which would prohibit allocating IPO shares to officers or directors of companies that (1) have been investment banking customers in the past 12 months; (2) may reasonably be investment banking customers within the next six months; or (3) in consideration of an express or implied promise to be an investment banking customer).

For most founders of start-up companies, letting investment banks and institutional investors skim off the top of the total IPO pie is part of a very lucrative deal for them. Many founders become amazingly wealthy in their IPOs, so they are content to forego some portion of operating capital for the issuer. However, savvy officers of seasoned companies are becoming disillusioned with the bookbuilding process.[21] Companies that eventually went bankrupt after going public during this period are in litigation now with investment banks, alleging that underpricing lost them much needed capital.[22] But even with this excessively high transaction costs of going public, few issuers have a viable alternative to the bookbuilding system or the market power to forego Wall Street.

2. Bookbuilding v. Auctions

Although bookbuilding is by far the most prevalent IPO mechanism, alternative methods are used in other countries. In Singapore, Finland, and the United Kingdom, underwriters announce an offering price and investors submit demands for shares at that fixed price.[23] Shares are then allocated to the bidders in a random fashion. The fixed price method alleviates the discriminatory allocation problem inherent in bookbuilding, but does not address the ability of the underwriter to underprice the shares. However, without the ability to parcel out underpriced shares to chosen recipients, underwriters might have less incentive to underprice. Alternatively, IPO shares can be distributed through an open auction process, used in Israel and in France.[24] In an internet auction, bidders would place orders based on the number of shares that they would purchase at given prices. The highest price at which all shares would be purchased would be the offering price. Successful bidders would be allocated shares based on the offering price, and if the offering would be oversubscribed at the offering price, then bidders would receive a pro rata allocation of shares. No shares would be pre-allocated to either individuals or institutions.

In the purest form of online auction, the underwriter will have either no discretion or very little discretion in determining either the price of the IPO shares or the recipients of the distribution.

[21] *See* Shawn Tully, *Betrayal on Wall Street*, Fortune, May 14, 2001, at 84 (describing billionaire H. Ross Perot as being "outraged" when institutional investors flipped shares of Perot Systems after its 1999 offering for a $180 million profit); *see also* John C. Coffee, Jr., *The IPO Allocation Probe: Who is the Victim*, N.Y.L.J., Jan. 18, 2001, at 5 (describing as dysfunctional an IPO system that sees up to 75 percent of the market value of the IPO shares going to either underwriters or institutional investors and not the issuer).

[22] *See* John Caher, *N.Y. High Court Imposes Fiduciary Duty on IPO Underwriter Goldman Sachs*, Law.com, June 6, 2005, available at http://www.law.com/jsp/article.jsp?id=1118135115736.

[23] Bruno Biais and Anne Marie Faugeron-Crouzet, *IPO Auctions: English, Dutch, French, and Internet*, 11 J. Fin. Intermediation 9 (2002).

[24] *Id.* at 10.

The highest bidders will be the recipients of original IPO shares, with some exceptions. Because the resulting offering price should reflect full demand for the IPO shares, this auction process should lead to less underpricing and theoretically no run-up in share price on the first day.

Understandably, underwriters in the U.S. have not embraced online IPOs. To do so would mean the end of a system that grants underwriters a monopoly on IPO shares that are used to reward and entice selected recipients. Issuers generally choose an underwriter early in the IPO decision-making process, and unless that underwriter is the one firm in the U.S. that offers online IPOs, that underwriter probably will not counsel the issuer to investigate the pros and cons of an online IPO. The underwriter would not only be giving up some control of the underwriting process to another underwriter, but also would be giving up control of the allocation process, a lucrative opportunity to use other people's capital to curry favor with other Wall Street players. In addition, underwriters may be loath to implement their own auction mechanisms and thereby eliminate an allocation system that allows them to reward and entice their regular customers.

Most new issuers have few choices in negotiating with investment banks to underwrite their IPOs. Although issuers may lose capital because of underpricing, the founders may be satisfied with the profits from finally being able to sell their shares in the secondary markets. In addition, the founders of the IPO company may not want to forego the potential upside of reserved directed shares for friends and family and the ability to build in gain for themselves and their strategic partners.[25] Founders often rely on venture capital firms to choose investment banks, and VCs also may be hesitant to forego instant profits.[26] Most frustratingly, founders also find themselves recruited into this scheme whereby they allow their investment bank to underprice shares of their company and then receive allocations in future hot IPOs from that bank.[27]

[25] Many start-ups during the 1999-2000 Boom engaged in a fragile house of cards in which the start-up would promise IPO allocations to executives of strategic partners in exchange for the strategic partners entering into lucrative contracts with the start-up. These lucrative contracts were the basis for the business plan on which the IPO was launched. *See* Hurt, supra note 2, at 745-48 (describing one scenario involving Sycamore Networks and Williams Communications).

[26] *See* Jill E. Fisch & Hillary A. Sale, *The Securities Analyst as Agent: Rethinking the Regulation of Analysts*, 88 IOWA L. REV. 1035, 1050 (2003) (noting that some venture capital firms are even divisions of investment banking firms).

[27] For example, eBay used Goldman Sachs as its lead underwriter in its 1998 IPO, and seven directors of eBay accepted IPO allocations from Goldman in over 200 offerings between 1998 and 2001 that were worth millions of dollars to those directors. *See In re* eBay, Inc. Shareholders Litig., No. Civ. A. 19988-NC, 2004 WL 253521 (Del. Ch. Jan. 23, 2004) (detailing claims of shareholders that the directors receiving IPO shares breached their fiduciary duty of loyalty to eBay shareholders by usurping a corporate opportunity).

The other major Wall Street player, the institutional investor, has also been spoiled by huge short-term gains from IPO allocation, as have arbitrageurs and day traders, and so will not be attracted to the auction structure. Ironically, because the auction process may entail "winner's curse" problems, the share price may actually decline the first day. Because the IPO process creates profitable short-term opportunities for the professional investor, these constituents will use their consumer power to maintain the bookbuilding status quo. ,Unfortunately, the main players that gain from the bookbuilding system are necessarily the ones that have the power to choose the format, which will hamper the growth of the online IPO.

Industry resistance aside, the availability of online IPO auction mechanisms promises a much more democratic IPO process whereby the larger public has the opportunity to participate. Theoretically, the enhanced transparency of pricing and participation of investors should create a more efficient market for IPOs in which the offering price more accurately reflects the value investors place on the IPO shares. The elimination of the bookbuilding method would completely transform the IPO process, eliminating opportunities for profit allocations that spawn other unfair practices such as spinning and laddering. Although the SEC and the NASD refuse to prohibit this practices, these practices would effectively disappear should online auctions proliferate and flourish.

B. *The SEC and Online Auctions*

Technically, true IPO auctions would violate federal securities laws. SEC rules prohibit both selling and offering to sell securities prior to the registration statement for those securities becoming effective. The registration statement for a security cannot become effective until the final price is indicated by the issuer. In an auction, bidders make binding offers to buy shares, and the seller accepts these offers at the highest price at which all shares will be sold. This process sets the final price. Therefore, in a true auction, the final price cannot be set before buyers must make unconditional bids for the securities and those bids are unconditionally accepted by the seller. Beginning in 1999, investment banks began asking the SEC to issue no-action letters confirming that online auctions would not run afoul of SEC rules regarding offerings.

The first no-action letter that the SEC issued was to Wit Capital Corporation, the first online investment bank, in July 1999,[28] which stated that Wit Capital could sell shares in an online initial public offering; however, bids from prospective buyers would be considered mere "indications of interest" and would remain open until 48 hours before the registration statement would become effective. At that time, Wit Capital would send emails to all bidders to reconfirm their bids, at which time the bids would become offers. Wit Capital would then determine the winning price of IPO shares and submit a price amendment to the SEC. Wit Capital would then accept the highest offers after the registration statement became effective. The end result of this compromise was that the

[28] *See* Wit Capital Corp. SEC No-Action Letter, 1999 WL 49854 (July 14, 1999) [hereinafter 1999 Wit Capital Letter].

process described in the Wit Capital letter was an amalgam of a true auction and the bookbuilding process. For example, Wit Capital disclosed that it would reserve the right to set aside directed shares that could then be allocated to "employees or customers of the issuer or other persons with an affinity relationship with the issuer." Wit Capital also indicated that it would allocate no more than 100 shares to any bidder until all winning bidders had been allocated 100 shares. Other innovative investment banks, which had emerged during the technology boom, followed suit.[29]

Wit Capital also requested a second no-action letter in 2000 that would extend its auction mechanism to follow-on and secondary offerings to be priced and distributed in a Dutch auction format.[30] However, Wit Capital did not specify whether the revised format would also be used in connection with IPOs. In the proposed Dutch offering, the bidders would be asked to bid for shares between a given maximum bid price and a minimum bid price.[31] The offering price would then be set at the clearing price, the highest price for which all shares would be sold up to the maximum bid price. If the offering was oversubscribed at the offering price, then the issuer would allocate the shares to the bidders based strictly on the highest price bid by the bidder and the time of the bid.[32] The auction would be truly transparent, allowing any Internet user to view the aggregate demand in the auction at any price point. In addition, each bidder would have the ability to change or cancel bids prior to the termination of the auction. Although the bids would be anonymous, the issuer and the underwriter could agree to adjust the allocation to ensure that at least 25 percent of the allocation would be received by small bidders or large bidders, as the case may be.[33]

Although several investment firms created infrastructure to offer equity securities and debt securities in an online auction process, most, including Wit Capital, abandoned the practice after the end of the 1999-2000 Boom. Ironically, the firms most likely to want to go public via an online auction, technology firms and web-based businesses, were the very firms hit hardest by the bursting of the technology bubble and the least likely to go public in large numbers for some time. Although only one of the companies at the forefront of online IPOs is still active in that industry, pioneers such

[29] *See*, *e.g.*, W.R. Hambrecht + Co., SEC No-Action Letter, 2000 WL 987735 (July 12, 2000) (seeking guidance for the online issuance of debt securities. Even traditional investment banks began making plans for online securities platforms. *See* Bear, Stearns & Co., Inc., SEC No-Action Letter, 2000 WL 1013584 (July 20, 2000) (seeking guidance for the online issuance of investment-grade debt securities).

[30] *See* Wit Capital Corp., SEC No-Action Letter, 2000 WL 1013585 (July 20, 2000) [hereinafter 2000 Wit Capital Letter].

[31] *See id.* at *3.

[32] *See id.* at *4.

[33] *See id.*

as Wit Capital helped create a regulatory atmosphere that allows IPO auctions to take place.

C. *W.R. Hambrecht + Co.*

Although most traditional brokerage firms accept electronic orders for IPO shares from individuals, few have developed a system whereby all original IPO shares can be distributed via the Internet in an auction format. In addition, of the firms that developed an online auction system during the 1999-2000 Boom, only W.R. Hambrecht + Co. currently maintains an online IPO auction platform in the U.S.[34] W.R. Hambrecht, after 40 years in traditional investment banking at his own firm, Hambrecht & Quist, publicly spoke out about the abuses of the IPO process and started this new investment banking firm[35]

Prior to the Google auction, Hambrecht had launched ten companies over approximately five years using an online IPO auction process called OpenIPO, including Red Envelope, and Peet's Coffee & Tea.[36] In 2004 only one firm, New River Pharmaceuticals, Inc., had used the OpenIPO platform for its IPO, a $36.6 million offering completed in August of that year. Two firms, Genitope Corporation and Red Envelope, Inc. used the auction format for their 2002 IPOs, and Overstocks.com went public in 2001 using OpenIPO. As these numbers make clear, very few companies launch online IPOs, barely one or two a year. Of these companies, many are companies born of the Internet, like Red Envelope and Overstocks.com, or companies with a reputation for nonconformity, like Peet's Coffee & Tea, the "anti-Starbucks."[37]

D. *IPO Advisory Committee and the NASD*

On August 22, 2002, the former Chairman of the SEC, Harvey Pitt, had asked the former Chariman of the New York Stock Exchange, Dick Grasso, and the Chairman of the NASD, Robert

[34] *See* www.openipo.com.

[35] *See generally, Interview Bill Hambrecht*, Frontline, available at http://www.pbs.org/wgbh/pages/frontline/shows/dotcon/interviews/hambrecht.html (quoting Hambrecht as saying, "Instead of a situation where you're hired as an underwriter to place the stock with people who are going to be the long-term shareholders, when you get into volatile hot markets where you get this unusual first-day trading profits, there's a tremendous propensity to give that stock to your best client. And they in turn sell it and take a quick profit, and then the long-term buyer, the guy you wanted in the first place, ends up buying it in the volatile aftermarket.")

[36] *See* www.openbook.com (listing the tombstones of completed online initial public offerings).

[37] *See* Eric A. Taub, *Rival Moving Beyond Roots Entwined With Starbucks*, N.Y. TIMES, June 4, 2005, at C4 (quoting a Peet's afficianado as saying that she preferred Peet's to Starbucks partly because "it's not part of an evil empire").

R. Glauber, to convene a committee of leaders in both the business and academic communities to assess the current problems in the IPO process.[38] This committee was to focus on why IPO prices would increase dramatically at the beginning of an offering and how this phenomenon contributed to aggressive and possibly illegal underwriting practices. In May 2003, the NYSE/NASD IPO Advisory Committee released a document entitled "Report and Recommendations" that detailed the committee's recommended improvements to restore the integrity of the IPO process.[39]

Although the committee's report does not denounce the bookbuilding process,[40] the committee recognized that investors had lost confidence in the IPO market to the "widespread perception that IPOs are parceled out disproportionately to a few, favored investors, be they large institutions, powerful individuals or 'friends and family' of the issuer."[41] However, although the report supports alternatives to bookbuilding, such as Dutch auctions, the report clearly states that the Committee did not believe that bookbuilding was "inherently flawed" or that regulation should eliminate or even disfavor the traditional bookbuilding method. Instead, the committee left the market for IPOs to determine the dominant method of IPO distribution.

III. The Google Auction

Just as most industry watchers had forgotten about online IPOs, Google announced that its highly anticipated IPO would be launched in an auction format.

A. *Google, the Company*

In some ways, Google Inc. is a typical dot.com company that emerged in the technology boom of the 1990s as one of many start-ups created by two smart kids with a great idea. Larry Page and Sergey Brin had met at Stanford as students and by 1998 had $1 million in angel investor money to launch their own search engine to compete with Yahoo, Lycos, Altavista and others. Google.com become a hugely successful search engine that markets itself as being able to retrieve the most

[38] *See* NYSE/NASD IPO Advisory Committee, Report and Recommendations of a Committee Convened by the New York Stock Exchange, Inc. and NASD at the Request of the U.S. Securities and Exchange Commission (May 2003) at Appendix A.

[39] *See id.*

[40] *See id.* at 9 (stating the conclusion of the Committee that although auction should be supported by the SEC, that bookbuilding should not be eliminated or disfavored).

[41] *See id.* at 2.

relevant webpages based on user's search terms.[42] By design or sheer luck, Google did not go public during the 1999-2000 Boom, although many technology companies with little or no record of earnings did choose to go public during that time, only to eventually fail. In fact, numerous search engine companies failed during this time or underwent massive restructuring.[43] Google continued to prosper and is now not only the pre-eminent search engine website but also the fifth most popular website in the world. Internet users can harness the power of the Google search engine at no cost, so Google depends on advertising for revenue. Google's AdWords program generates sidebar ads for vendors on the Google website based on user's search terms. A portion of Google's ad revenue is based on the number of users who click on those sidebar ads. Google also maintains a network of "thousands of third-party websites" that use Google's AdSense program to generate ads on their own websites.[44] Altogether, 95% of Google's revenue is derived in some way from advertising.

B. *Waiting for Google: Anticipating the Auction*

In 2004, nothing captured the imagination of Wall Street like the announcement by Larry Page and Sergey Brin that not only would Google finally participate in a public offering but also that the public offering would be an online auction. The founders explained that this auction would embody both the innovative mindset and democratic spirit of Google.[45]

1. Google's Registration Statement

In Google's April 29, 2004 registration statement, the founders departed from the traditional S-1 format to write a letter to investors explaining how Google was going to be different than other public companies.[46] First, the founders explained that they chose an IPO auction format because they felt that the inefficiencies inherent in the traditional IPO process were damaging to both the issuer

[42] For a thorough examination of Internet word search providers, *see generally* Eric Goldman, *Deregulating Relevancy in Internet Trademark Law*, 54 Emory L.J. 509, 511 (2005).

[43] Lycos was sold twice, once in 2000 to Terra Networks, S.A., and again in 2004 to Daum Communications Corporation. Altavista's parent was bought by Compaq, which spun off Altavista stock in _____. Altavista was eventually bought by Overture Services, Inc., which was then bought by Yahoo in 2004.

[44] http://investor.google.com (last visited March 30, 2005).

[45] *Google's Dutch Treat*, WALL ST. J., May 3, 2004, at A20 ("In a sense, this auction is the perfect IPO expression of Google's own business model. The company's success has derived from its ability to democratize access to information via the Internet, and its auction will likewise open its shares to a wide spectrum of investors.").

[46] Google Inc., Registration Statement (Form S-1), at ___ (April 29, 2004) [hereinafter "Form S-1"]

and the long-term investor.[47] On that note, the founders urged investors to invest in the company only as a long-term investment and warned that the company was not interested in hitting short term financial benchmarks at the expense of long-term productivity.[48] Short-term investors would be disappointed with the auction process, which might result in no share price increase the first day of trading.[49]

Despite Google's efforts to use the auction as an example of how the company was different from other technology companies that went public and saw their share prices soar, only to then disintegrate in balance sheet scandals, detractors were quick to point out that Google's auction process was not a true Dutch auction. In a true Dutch auction, anyone would be able to bid, and the clearing price would determine the offering price.[50] At first blush, Google's auction did not seem that democratic. First, Google initially chose two traditional underwriters for its auction, Morgan Stanley and Credit Suisse First Boston. These investment banks are not known for IPO innovation and in fact had never offered an online IPO auction before. All other IPO auctions in the U.S. had been handled through W.R. Hambrecht + Co. Second, to participate in this auction, prospective investors would need to open an account with one of these two firms. To ensure that only serious bidders would participate in the auction, these firms required that prospective investors maintain extremely high minimum balances in their accounts and be adjudged "accredited investors."[51] The rumors flew that to create a qualifying account at one of these firms would require a balance of $1 million.[52]

2. First Amendment to the Registration Statement

In response to this criticism, the first amendment to the registration statement, filed on May 21, 2004, added twenty-nine additional banks as underwriters, including smaller banks and online banks, such as E*Trade.[53] Among the twenty-nine were traditional Wall Street firms such as Merrill

[47] *Id.* at ___.

[48] *Id.* at ___.

[49] *Id.* at ___.

[50] Eugene Choo, *Going Dutch: The Google IPO*, 20 BERKELEY TECH. L.J. 405, 414 (2005) (citing Paul Milgrim, *Auctions and Bidding: A Primer*, 3 J. ECON. PERSP. 3, 6-7 (1989)).

[51] Form S-1, *supra* note 46, at ____.

[52] John E. Fitzgibbon, Jr., *Passing Parade: Google Hype vs. History*, www.123jump.com (last accessed March 30, 2005).

[53] Google, Inc., Amendment No. 1 to Registration Statement (Form S-1), at 25 (May 21, 2004) [hereinafter "Amendment No. 1"].

Lynch and Goldman Sachs, who were in the uncommon position of being part of a large syndicate without being named as co-lead underwriters. The addition of these firms seemed to open up the bidding to a larger number of investors as many of the smaller banks required only a $2000 minimum account balance. However, as the registration process continued, several larger banks dropped out and were omitted in subsequent registration statement amendments; for example, Merrill Lynch reportedly dropped out after estimating that it would lose money on the effort.[54]

The first amendment to the registration statement also contained five pages that detailed the risks inherent in the auction process.[55] In a true auction, the winners may be said to experience the "winner's curse," because an auction winner by definition values the product at an amount higher than anyone else.[56] Moreover, because the auction price will be the highest price that anyone has offered to pay, the price may indeed decline over the first few days of the offering. Of course, to an unsophisticated investor, the first-day pop may be reflective of the value of a company; therefore, if now-defunct issuers such as Webvan[57] could see their share prices double in the first day of an offering, then Google's share price should double, or even triple. However, because the auction format is designed to capture the demand buzz in the auction price, not in the first day closing price, that pop should not happen. Knowing that some investors would want to participate in the Google IPO in order to experience a big, first-day "pop," Google management tried to inoculate the market from that disappointment.[58]

The first amendment identified another risk in an attempt to ward off post-auction backlash: the risk that the auction process might actually hurt Google's brand instead of enhance it.[59] "Should either the auction structure fail or users get frustrated with the process, then that negative public

[54] *See* Bill Diener, *Google IPO May Not Live Up to Its Hype*, Dallas Morning News (August 8, 2004), at __ (hypothesizing that Google's demand to reduce underwriting fees from seven percent to three percent drove Merrill Lynch out of the underwriting syndicate).

[55] Amendment No. 1, *supra* note 53, at 18-22.

[56] Larry T. Garvin, *Disporportionality and the Law of Consequential Damages*, 59 OHIO ST. L. J. 339, n. 376 (1998).

[57] Webvan, an online grocery delivery service, went public in November 1999, and its shares climbed 73 percent in its first day of trading. However, such euphoria was short-lived as Webvan declared bankruptcy on July 13, 2001. *See* Jenny Strasburg, *Five Years After the Bubble Popped NASDAQ up 85% since Nadir in 2002*, S.F. CHRON., Mar. 10, 2005, at C1.

[58] Amendment No. 1, *supra* note 53 at 18 ("Therefore, buyers hoping to capture profits shortly after our Class A common stock begins trading may be disappointed.")

[59] *Id.* at 19 ("The systems and procedures used to implement our auction and the results of our auction could harm our business and our brand.")

reception could reflect badly on Google products.'"[60]

3. Second Amendment to Registration Statement

Although the first amendment warned of the risk of the share price deflate due to "a lower level of participation by professional long-term investors and a higher level of participation by retail investors,"[61] the second amendment was even more explicit about the winner's curse phenomenon and the possibility of unsophisticated bidders artificially driving the offering price. A new risk factor was added that addressed the possibility that "less price sensitive investors" would drive the auction clearing price beyond the true market value of the shares.[62] Google warned prospective investors that a large number of unsophisticated investors with brand awareness of Google but lack of access to extensive research and analysis would have access to bidding in the IPO. These "less price sensitive investors'"[63] could drive the price above the fundamental value of a Google share. Not only might the share price not increase dramatically during the first day, but it also might decrease. The amendment warned that "the offering price of our shares may have little or no relationship to the price that would be established using traditional indicators of value. . . . As a result, [the] initial public offering price may not be sustainable.'"[64]

The second amendment also began a conversation on another important topic: the selling of insider shares. The Google management emphasized that no Google insiders other than Page and Brin would be contractually obligated to hold their shares once the offering were underway.[65] In other words, no underwriter was requiring that the inside shares not being sold in the offering would be subject to a lock-up agreement. In most IPOs, the underwriter requires insiders to hold their shares for a certain number of days, such as 90 days or 180 days.[66] Because the sale of a large amount of shares on a given day can drive the share price down, the underwriter uses these

[60] *Id.* at __.

[61] *Id.*, at 18.

[62] Google, Inc., Amendment No. 2 to Registration Statement (Form S-1), at 19-20 (June 21, 2004) [herinafter "Amendment No. 2"].

[63] *Id.* at __.

[64] *Id.* at 20.

[65] *Id.* at 120.

[66] Deborah A. Marshall, *Latest Trends with Lock-ups and Other Underwriting Arrangements*, in SECURITIES LITIGATION 2000 (PLI Corp. Prac. Course, Handbook Series No. B0-00LK, 2000), at 363, 367.

agreements to maintain a high share price for as long as possible. The underwriter can waive the lockup requirement at any time, and regularly does so if the share price remains high.[67] If the share price plummets, the underwriter may even ask insiders to extend lock-up terms to stave off a price decrease.[68] This type of underwriter price management is arguably manipulative and inefficient, and Google stressed that an unrestricted system would make the system more transparent. Although Page and Brin "entered into contractual lock-up agreements with our officers and directors and certain of our employees and other securityholders."[69] Allowing the other insiders to sell their large numbers of pre-IPO shares at their discretion also roused criticism. Many thought that Google management, in a role similar to an underwriter, could then manage the stock price through pressuring employees and relatives to hold or sell.[70]

4. Fourth Amendment to the Registration Statement.

By the fourth amendment, Google management had compromised on the issue of lockup agreements and described the details of an agreement between Google and holders of restricted securities that would gradually allow more insider shares to become available for sale after 15, 90, 120, 150, and 180 days.[71] Even after this disclosure, Google admitted that the short duration of "the selling restriction agreements between us and our stockholders will allow significantly more shares to become freely tradeable soon after completion of the offering than is typical of initial public offerings."[72] Accordingly, analysts were unimpressed with the details of this agreement, noting that according to Thomson Financial, no IPO in the last two years was launched without insiders agreeing to a lock-up period of at least 180 days.[73] The head of one Wall Street firm complained that allowing insiders to sell their shares so quickly was not consistent with Google management's expressed focus

[67] Fisch & Sale, *supra* note 26, at 1050-51 (explaining that the realistic length of a lockup agreement is entirely within the discretion of the underwriter, who can unilaterally waive the lockup agreement).

[68] *See* Marshall, *supra* note 66, at 387-88.

[69] Amendment No. 2, *supra* note 62, at 120.

[70] Deborah Lohse & Michael Bazeley, *Google Debut Losing Luster*, SAN JOSE MERCURY NEWS (August 8, 2004), at A1 (noting that pre-IPO, three times as many shares were held by Google insiders than in an average IPO).

[71] Google, Inc., Amendment No. 4 to Registration Statement (Form S-1), at 110-11. (July 26, 2004) [hereinafter "Amendment No. 4"].

[72] *Id.* at ___.

[73]

on long-term investing.[74] Analysts feared that the large amount of outstanding pre-IPO stock available for sale would eventually dilute the share price.[75] Of course, this risk was outlined in the Google registration statement, a fact that caused others to note that the information on the lock-up restrictions would discount the share price, so the eventual sale of insider stock shuld not affect the share price.[76] This confidence in the efficiency of the market was not good news to Google management, however, who would not want the market to discount its IPO shares when bidding during the auction.

The biggest surprise in the fourth amendment had nothing to do with the lockup agreements; most interestingly, the fourth amendment included the estimated price range for the original IPO shares. The company estimated that the offering price would be between $108 and $135 per share.[77] U.S. auctions generally do list a range of prices, but this range seemed extremely high to many analysts. Obviously, the share price is irrelevant without taking into account the number of shares outstanding, but most IPOs in the United States are priced much lower to increase liquidity, usually no more than $20 or $30 per share.[78] If Google priced in this estimated range, it would be ranked as the second highest IPO offering share price of all time.[79] Analysts speculated that the high price range was designed to keep out the rabble.[80] Google and the underwriters were concerned about the volume of interest, particularly unsophisticated interest, that might destroy the integrity of the auction process. If the offering price were sufficiently high, then only serious bidders would participate in the offering. Of course, the price could also have reflected the issuer's sense of the market demand for the shares at that time. If Google management believed that the price would rise to this level in the first few days of the offering, then setting the range this high would ensure that this demand would be captured by the issuer, not the resellers.

The fourth amendment also detailed that Google planned on selling 24,636,659 shares total,

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[75] Kathleen Pender, *Google Fumbled a Good Idea*, S.F. CHRON. (Aug. 19, 2004), at A1.

[76]

[77] Amendment No. 4, *supra* note 71, at 1.

[78] *See* Russ Wiles, *IPO for Google Not Democratic on Second Viewing*, Ariz. Republic (Aug. 18, 2004), at D5 (stating that out of 160 IPOs in the twelve months prior to the Google IPO, only 4 IPOs opened with an offering price over $25, and none of those prices were above $30).

[79] *See id.* (noting that no IPO in recent memory opened with a three-digit price).

[80] Kevin J. Delaney & Ruth Simon, *Google's IPO Draws Lukewarm Interest From Small Investors*, WALL ST. J., Aug. 9, 2004, at C1 ("Google may have set a high share price estimate to dampen interest among individuals.")

of which 10,494,524 would be shares currently issued and owned by Google stockholders.[81] Specifically, given the $105-135 range, Google could net as much as $1.6 billion from the sale if the shares priced at the midpoint.[82] If the high price range truly reflected the high demand for Google shares, then the demand would be captured by Google's insiders, specifically Brin, who was planning on selling 962,226 shares, and Page, who planned to sell 964,830 shares, or roughly $130 million each at the $135 offering price.[83] Notably, these shares constituted less than 3% of either Brin's or Page's holdings in the company.[84] Priced at this range, the underwriters would share more than $90 million in fees at the discount rate that Google had negotiated: 3%, compared with 7%.

5. The August Slump

The high price range of $108-135 seemed destined for a fall as the registration process continued. In August, critics speculated that demand for Google shares was waning. Institutional investors were also less than exuberant. Institutional investors, of course, found themselves in the unfamiliar and unenviable role of having to bid against retail investors in an auction that likely would not produce any short-term gains.[85] Because institutional investors are accustomed to being pre-allocated IPO shares and the selling them in the next few days at a profit, the Google IPO did not provide much attraction for the institutional investor.[86] In addition, these institutional investors had a vested interest in seeing this auction experiment fail, and with it, any challenge to the status quo of bookbuilding offerings.[87]

Faced early on with the specter of irrational retail investors crowding out institutional investors, Google may have attempted to dampen individual investor demand by setting the share

[81] Amendment No. 4, *supra* note 71, at 1.

[82] *Id.* at 43.

[83] *Id.* at __.

[84] *Id.* at __.

[85] *See* Aaron Lucchetti, Robin Sidel, and Ruth Simon, *The Searchers: With Eyes for Google, 3 Investors Ride a 111-Day Roller Coaster*, Wall St. J., August 20, 2004, at A1 (describing how a hedge fund manager felt some concern at being forced to "fly blind like everybody else" instead of being able to "bully underwriters overseeing the deals into giving them a healthy cut of shares before they start trading").

[86] Investment guru James Cramer advised investors that the Google offering would suffer an initial slump because "[i]nstitutions, mutual funds and hedge funds are boycotting the deal." Cramer advised buying shares during the post-IPO slump.

[87] *Google's IPO Rollercoaster*, ECONOMIST, Aug. 19, 2004.

price range high and by issuing doomsday like warnings in its registration statement.[88] These tactics may have worked too well as retail investors did seem wary of the Google auction and the high share price range.[89] In addition, the description of the auction process may have daunted retail investors, who would have to register with both Google and a participating brokerage firm. This two-step process, discussed in Section III.C., infra, may have frightened away as many investors as the high price range.[90]

Other factors were also adding to the Google backlash in addition to the labyrinthine auction process and lofty price range. Some commentators opined that Google was losing its competitive edge over Yahoo, with its share of the search market destined to fall.[91] Relatedly, Google had settled a patent infringement suit with Yahoo in August for $300 million worth of stock.[92] Even Google's new email product, Gmail, was being criticized for privacy concerns.[93] Computer giant Microsoft was also developing its own search product, which would challenge Google's market dominance.[94] Relatedly, Wall Street speculated that growth in the Internet-search sector was slowing.[95] In fact, the NASDAQ, the listing choice for many technology companies, was down 15% from January.[96] Perhaps coincidentally, August, typically a vacation month for many,[97] is traditionally a slow month

[88] *See* Delaney & Simon, *supra* note 80, at C1 (citing an example of a first-time stock investor who had declined to buy Google shares after the $108-135 range was announced.)

[89] *Id.*(citing an example of a first-time stock investor who had declined to buy Google shares after the $108-135 range was announced.)

[90] *See* Lucchetti, et al., *supra* note 85 (quoting an individual investor who ultimately decided not to invest because of the cumbersome bidding process as saying, "'It seemed like every day there was something new we had to do. I didn't feel like I had the time.'").

[91] *See Rollercoaster*, *supra* note 87, at __; *Dutch Treat*, *supra* note 45, at __ (remarking on the threat of competition from Yahoo and Microsoft).

[92] *See Rollercoaster*, *supra* note 87, at __

[93] *See id.*

[94] Pete Barlas, *Google Bidders Grapple with its Valuation*, Investor's Bus. Daily (Aug. 2, 2004), at __ (quoting an analyst as saying if "Microsoft is spending a boatload of money on search," then "the valuation [of Google] goes down").

[95]

[96] *See Rollercoaster*, *supra* note 87 at __

[97] *See* Lucchetti, et al., *supra* note 85 (quoting a mutual fund manager who never believed that the IPO would take place in August "because 'everyone has gone to Nantucket or the Hamptons.'").

for stocks and for IPOs in general. In the two weeks leading up to Google's offering, ten other deals were cancelled.[98]

The registration process was also hitting some marketing snags. First, Google's road show was getting negative reviews.[99] Besides receiving very little financial information, investors were put off by the dual classes of stock, which gave B class holders, Google insiders, 10 votes per share. [100] Second, some retail investors were frustrated by certain underwriters' restrictions on bids and rejection of accounts due to suitability concerns.[101]

6. Seventh Amendment to the Registration Statement

Amid negative press focusing on everything from the auction to Google's business plan to the tech industry as a whole, the bidding process was scheduled to begin on August 13. Unfortunately, one more shoe would drop before the auction would open, and it would drop in a plain brown wrapper. On August 12, the latest issue of *Playboy* magazine hit the newsstand, complete with a seven-page interview with Page and Brin.[102] Although the interview was given before the filing of the registration statement in April and the beginning of the quiet period, investors became concerned that the publication of the interview during the quiet period could cause regulatory problems. During the quiet period, the issuer cannot speak publicly about the offering, yet in the magazine, the spokesmen for the issuer were definitely talking. On August 13, after discussions with the SEC, Google filed the seventh amendment to the registration statement, in which management disclosed as a risk the fact that the Playboy interview could create liability for Google for violating the SEC quiet period.[103]

7. Friday 13, 2004 – Bidding Begins

[98] Knowledge Wharton, *Lessons From Google's IPO*, AltAssets.com (last visited March 30, 2004).

[99] Pete Barlas, *Google's Glitch Likely to Delay Launch of IPO*, INVESTOR'S BUS. DAILY, Aug. 9, 2004.

[100] *See* Matt Kranz, *Whiz Kids' Blunders Blacken IPO's Eye*, USA TODAY (Aug. 19, 2004), at B1.

[101] *See* Michael J. Martinez, *Despite Billing, Google IPO Isn't Just For Everybody*, SEATTLE TIMES, Aug. 12, 2004, at E1 (describing Fidelity's $100,000 minimum account balance and Ameritrade's extensive questionnaire that resulting in the reporter's not being eligible, presumably because of a low net liquid worth).

[102] *Google Guys*, PLAYBOY (Sept. 2004).

[103] Google, Inc., Amendment No. 7 to Registration Statement (Form S-1) (Aug. 13, 2004) [herinafter "Amendment No. 7"].

All of these negative factors together assured that bidding would not open with a bang. Indeed, the bidding opened slowly on Friday the 13th of August. Prior to the start of the bidding process, any investor who wished to bid on the IPO shares was required to have completed the registration process. Registration included not only applying for a bidder identification number at a Google website, www.ipo.google.com, but also opening a qualifying account at a participating investment firm.[104]

C. *Google on the Auction Block: The Auction Arrives*

Google's prospectus gave detailed instructions regarding the auction process and described five stages: qualification, bidding, auction closing, pricing, and allocation.[105] The first step, qualification of prospective bidders, had ended on August 12. August 13 marked the beginning of the second step, bidding. Bidders could submit bids to any of the twenty-eight underwriters listed in the seventh amendment via Internet, telephone, fax, or hand delivery. When bidders submitted bids, they agreed to accept electronic delivery of all notices concerning the auction process. Not only could bidders change or withdraw bids during the bidding process, but management reserved the right to change the amount of shares sold and the price range. The prospectus specifically warned that "[i]t is very likely that the number of shares offered will increase if the price range increases."[106] The Google prospectus warned that in the event there would be a change in the price range or the number of shares offered, Google would post a notice on its website, issue a press release, and send an electronic notice to all bidders without requiring bidders to reconfirm their bids.[107] Although the bidding began on a specified date, the auction could be closed at any time, although bidders would have the right to withdraw bids after the closing of the auction, if the bids had not been accepted. Bidders would be notified both when Google requested that the SEC declare the registration statement effective and when the effectiveness was declared.

Once the registration statement would be declared effective, then the pricing process would begin. The prospectus stated that the issuer retained the right to reject bids that could potentially be manipulative,[108] and the issuers did reject some low-ball bids, but not others.[109] All bids not rejected

[104] Amendment No. 4, *supra* note 71, at 41.

[105] Amendment No. 7, *supra* note 103, at 34-35.

[106] *Id.* at 37.

[107] *Id.* at 37.

[108] *Id.* at 36 ("We, in consultation with our underwriters, will have the ability to reject bids that have the potential to manipulate or disrupt the bidding process. These bids include bids that we, in consultation with our underwriters, believe in our sole discretion do not reflect the number of shares that

were then used to determine the "clearing price," the highest price at which all of the shares offered would be sold. In a true Dutch auction, the clearing price is also the offering price. In the Google offering, the issuers stated their intention to use the clearing price as the "principal factor" in setting the IPO price, but retained the right to set the offering price below the auction clearing price. The stated reason for this reservation was to create a broader distribution of shares and "to potentially reduce the downward price volatility in the trading price of our shares in the period shortly following our offering."[110] In other words, Google returned the right to underprice below market demand, which could be beneficial if a winner's curse phenomenon seemed to be happening. Of course, the ability to underprice could also be abused.

After the offering price was determined, then Google would accept successful bids by sending electronic notices to those bidders. If the offering price was below the price range or more than 20% above the price range, then Google would send an electronic notice to bidders, who would then have one hour to withdraw bids before acceptance.[111]

1. Eighth Amendment to Registration Statement

While registered bidders were making bids and adjusting them, yet another misstep by management was revealed. Google filed its eighth amendment on August 16, 2004, which disclosed for the first time that Google was being investigated by the SEC and state regulators for large numbers of unregistered shares and options for shares that the company granted to service providers in the preceding three years.[112] Prior to this amendment, the prospectus merely referenced the risk that the company would have to rescind these shares at a cost of $25.9 million,[113] but the eighth amendment added the statement "We also understand that the Securities and Exchange Commission has initiated an informal inquiry into this matter and certain state regulators, including California,

you actually intend to purchase, or a series of bids that we, in consultation with our underwriters, consider disruptive to the auction process.")

[109] A Wall Street researcher bid $2 a share, which prompted a phone call from one of the underwriters asking him to confirm the price. That bid was ultimately rejected, but bids for $5 and $10 from the same bidder were accepted.

[110] Amendment No. 7, *supra* note 103, at 38.

[111] *Id.* at 39.

[112] Google, Inc., Amendment No. 8 to Registration Statement (Form S-1), at 19 (Aug. 16, 2004) [hereinafter "Amendment No. 8"]; *see also* Andrew Ross Sorkin, *Google Says It's Set to End Stock Auction*, N.Y. TIMES, Aug. 17, 2004, at C5 (noting that the potential liability could cause Google to repurchase shares at a price as high as $25.9 million).

[113] Amendment No. 7, *supra* note 103, at 19.

have requested additional information."[114]

After this latest news, Investors speculated that the offering would be postponed. However, on August 17, Google announced to investors via its website and electronic notices that it had formally asked the SEC to close the auction at 4 p.m. and would then announce the final share price by 5 p.m. This announcement led some investors to speculate that demand must have been sufficiently high, resulting in Google receiving enough bids to ask for the auction to close. Commentators also speculated that the bids received had to be in the suggested price range of $108-135 for Google to request final approval in the wake of the last filing.[115] Investors rushed to place bids before the auction ended. However, the SEC delayed effectiveness until the next day.

2. Ninth Amendment to Registration Statement

Early on August 18, any Google buzz created the night before was killed by Google's ninth amendment to registration statement, which lowered the estimated price range from $108-135 to $85-95,[116] causing some investors to slash their overpriced bids and others to switch to a low-bid strategy or opt out altogether. The company also reduced the overall number of shares sold, from 25.7 million to 19,605,052. This large reduction would be achieved by selling fewer insider shares being sold in the offering.

Wall Street seized on the lowering of the price range as a huge sign of weakness. One columnist took this opportunity to attack Google management for criticizing the bookbuilding process and choosing to have an auction:

> The "go it alone" method that Google used was a total fiasco, just ridiculous. The arrogance, the incompetence was beyond belief. Their own missteps and misbehavior have brought *much lower* prices than they ever would have gotten for the deal. Institutions, mutual funds and hedge funds all are boycotting the deal. So the price will be artificially *low*. These guys will have totally messed it up for themselves.[117]

3. Registration Statement Declared Effective

[114] Amendment No. 8, *supra* note 112, at 19.

[115] *Google's IPO Rollercoaster*, ECONOMIST, Aug. 19, 2004; Sorkin, *supra* note 112, at C5 (quoting David Menlow, president of IPO Financial Network: "I'm conclusion-jumping here, but it appears on the surface they have enough bids to where they feel good about pricing the deal.").

[116] Google, Inc., Amendment No. 9 to Registration Statement (Form S-1), at 1 (Aug.18, 2004).

[117] James J. Cramer, *How to Buy Google:* After *the Deal*, RealMoney.com, Aug. 18, 2004.

Finally, later in the evening on August 18, the registration statement was declared effective, and the auction closed. Google priced the shares at $85 per share, the bottom of the price range; all bidders who bid $85 per share or higher would receive shares. Any bids below $85 would be rejected, and those bidders would not receive any shares. Because Google reserved the right to deviate from the clearing price, no one outside the process can know if the clearing price was in fact $85 or if the clearing price was above or below that amount.

The final step in the process, the allocation process, was even more opaque than the pricing step. Google had reserved the right to allocate shares either in a pro rata allocation or in a "maximum share allocation" based on an algorithm that seemed to indicate that smaller bids would be wholly accepted while larger bids would receive a reduced number of shares. Although Google did not make the bids public, most critics believe that bidders received a 75% allocation. In other words, if a bidder bid $86 for 100 shares, then the bidder received 75 shares at $85 per share.

4. First Day of Trading

Online IPO auctions are designed to capture investor demand and reduce first-day share price increases; in fact, Google's S-1 had warned that in the first day of trading, the share price could even decrease. However, in the first day of trading, Google shares rose in price 18% from the offering price. Coincidentally and ironically, the average first-day share price increase for bookbuilding IPOs in the U.S is 18.8%. Moreover, after the third day of trading, the stock price was up 29%. This differential could reflect several scenarios. First, the clearing price may have been over $85, and the Google management underpriced the shares. Second, the Auction platform may have caused nervous investors to wait to buy until after the auction, creating two demand curves, one representing auction share demand and the other representing post-auction share demand. Third, the increased demand after the auction may reflect buying strategies of the professional investors who boycotted the auction and waited to buy in the aftermarket. The true answer is probably some combination of these three scenarios.

D. *Google Aftermath or Google Honeymoon?*

The first-day 18% jump was just the beginning of an almost continuous rise in the share price. From September 1 to November 1, the price rose steadily to $196 per share, reflecting a 130% profit over less than three months. Investor demand was so high in the first month that not even the expiration of the first lockup period, seen pre-IPO by analysts as impermissibly short, could affect the rising stock price. The additional 4.6 million shares injected into the market on September 2 were quickly snatched up by investors, and any momentary dip in share price was regained within a day or two.[118] Likewise, the share price dipped after the next two lockup expiration dates on November 16 and December 16, but the stock rose steadily again from $180 on December 17 to

[118] Zuckerman & Delaney, *Google's Stock Rise Nears 50%*, WALL ST. J., Sept. 29, 2004, at __.

$216.80 on February 2, 2005. The last lockup agreement expired on February 14, flooding the market with 90 million additional shares, almost doubling the public float.[119] This dilution caused the share price to decrease; however, the share price closed on March 28, 2005 at $181.42, a price that itself reflects an amazing 112% increase over seven months. Beginning May 2005, the stock price began to climb again, peaking close to $300 before closing at $286.70 on June 20, 2005, up 236%.

Once analysts employed by Google's underwriters began to cover its stock after the 40-day waiting period, those analysts were overwhelmingly positive in their "buy" recommendations, compared to investment banks that were not participants in the IPO.[120] Over time, analyst buy recommendations and high price targets,[121] combined with favorable earnings reports from Google, have supported the meteoric rise of the share price.

In addition, although some institutional investors chose not to participate in the online auction or participated only hesitantly, these important market movers jumped on the after-market bandwagon, with Fidelity Investments buying 15% of Google's Class A shares in the first month of trading.[122] Growing institutional investor demand supported the share price, and by December, 89% of Google's float was held by institutional investors.[123]

The rapid price increase over the first ten months of trading casts some doubt on the pricing of the Google IPO and on the auction process. Some analysts have attributed the rise in share price to a natural increase in the fundamental value of Google. They argue that the $85 initial price was suppressed due to the confusing auction process and unflattering disclosures made close to the offering date. The combined uncertainty surrounding both the substance and the process of the IPO

[119] Interestingly, Page, Brin, and CEO Eric Schmidt declined to sell all 177 shares restricted in the final lockup agreement, choosing instead to sell approximately 90 million at expiration, then 16.6 million more of their shares at intervals during an 18-month period. Google Form 8-K .

[120] Zuckerman & Delaney, *supra* note 118, at __ (reporting that CSFB, JPMorgan, Morgan Stanley, Thomas Weisel Partners, and Hambrecht gave price targets as high as $150).

[121] *Id.*(reporting that in the preceding few weeks, CSFB had targeted Google stock at $225; Goldman Sachs at $215; and American Technology Research at $210).

[122] Gregory Zuckerman and Kevin J. Delaney, *Google Rallies, Shakes Off Some of the Skeptics*, WALL ST. J., Sept. 29, 2004, at C1.

[123] Bambi Francisco, *Getting Google Religion: Even the Skeptics are Converting*, Marketwatch.com, Nov. 30, 2004, available at www.cbs.marketwatch.com.

reduced demand.[124] Others attribute the volatility in pricing to the small public float of Google shares.[125] Because only a small number of shares were available for sale in the first few months, demand exceeded supply, causing the price to rise. Only approximately 30 million shares were sold to the public in the offering, then lockup expirations slowly released another 93 million shares over five months, with another 177 million shares being released at the final lockup expiration on February 14. However, not all of those shares have been sold into the market; as of March 28, the *Wall Street Journal* reports that the public float is 128 million shares, compared to 273 million shares outstanding. As of June 23, the public float was only 180 million shares, following huge sell-offs by Page, Brin, and CEO Eric Schmidt in the past month. Even now, the public float is comparatively tiny compared with Yahoo, for example, which has had a public float during the same time period of 1.2 billion shares.

In addition, the market, especially the market for IPOs, was also strong in the second half of 2004. In October, 33 companies went public, the highest volume of IPOs in a month since August 2000.[126] There was some speculation as to whether this IPO boomlet helped Google, or whether the successful Google opening created an IPO tidal wave that floated all boats.

IV. Did Google Fulfill the Auction Fantasy?

Whether the Google auction was successful depends on what the criteria for a successful IPO auction are. To Wall Street, a successful IPO is one that creates "buy" orders in the first day, with excess demand increasing the share price. On the other hand, a proponent for the auction process will argue that a successful auction is one that prices the original IPO shares as close to the market price as possible. In fact, Hambrecht has been quoted as saying that an auction with a first-day pop of 10% or more is a failure. Therefore, the Google auction would have been a failure to at least one group of people no matter what happened on the first day of trading. Because Google shares did increase in price on the first day, supporters of online auctions criticized the auction process as not being a "true" auction. Auction opponents criticized the confusing auction and managerial missteps as destroying much of the value that could have been captured in the IPO and depressing the price. Google was criticized both for alienating institutional investors[127] and for scaring retail investors

[124] Jason Draho, *The Google IPO: What Happened and Why?*, vcexperts.com (last access March 30, 2005) ("A defining attribute of the Google IPO was the pervasive uncertainty.")

[125] Francisco, *supra* note 123.

[126] Raymond Hennessey, *IPO Outlook: Google's Surge Fuels Comeback for IPO Market*, WALL ST. J., Nov. 1, 2004, at C4.

[127] Mark Calvey, *IPO Rebel Defies Wall Street*, S.F. BUS. TIMES, Jan. 28, 2005 (quoting Thomas Weisel, CEO of Thomas Weisel Partners, one of Google's underwriters as saying the Google auction was

away.

For purposes of this analysis, this section will try to isolate the auction process and analyze it using three criteria of a successful IPO auction: a transparent process, a resulting market price for the shares, and a democratic allocation.

A. *Was it a True Auction?*

Experts on the auction method questioned the Google auction's mechanisms. For example, Alexander Ljungqvist[128] criticized the auction because it did not state a firm number of shares available[129] and it did not commit to a method for distribution if oversubscribed at a certain price. In fact, Google reserved the right to employ a "pro rata allocation percentage" calculation or a "maximum share allocation" calculation that would give small bidders their complete allocation, with larger bidders receiving a small portion of their total bid.[130] In addition, the registration statement noted that management did "not intend to publicly disclose the allocation method that we ultimately employ." For a mechanism that is designed to increase transparency in the IPO process, these reservations were inconsistent with that philosophy.

In fact, Google drastically changed both the price range and the number of shares available in literally the eleventh hour of the auction. Although the registration statement had indicated that the issuer might increase both the price range and the number of shares available if demand were high, the issuer had not described the opposite scenario.

In addition, the size of the auction and the participation of so many investment banks created a hybrid auction process in which a large volume of bidders were bidding at separate investment banks, and then those bids were consolidated onto a second auction platform. Because of anticipation of large number of bidders, the Google auction was not distributed through the

a failure because only two legitimate institutional investors participated in the auction, unlike in a bookbuilding IPO where the investment banker can hand pick interested institutional investors to receive original IPO shares). However, note that Weisel Partners was fined by the SEC in March 2005 for IPO abuses, including accepting excessive commissions in return for hot IPO allocations. *See* Weisel Press Release, *supra* note __.

[128] Ben White, *Aiming to Auction Its Way to a More "Inclusive" IPO: Complex Scheme Could Confuse Small Investors*, WASH. POST, April 30, 2004, at E1.

[129] Google, Inc., Amendment No. 3 to Registration Statement (Form S-1), at 36 (DATE) ("In addition, we and the selling stockholders may decide to change the number of shares of Class A common stock offered through this prospectus.") [hereinafter "Amendment No. 3"].

[130] *Id.* at 38-39.

Hambrecht OpenIPO platform. Instead Google had a gaggle of underwriters that had to modify existing procedures to accommodate the auction process.[131] Therefore, the process that Google created both by design and by circumstance was unique to Google.

B. *Did the Process Eliminate Underpricing?*

If the auction process is intended to eliminate underpricing by the underwriter, then Google management has to explain how this process created a first-day share price increase that is equal to the average first-day share price increase in bookbuilding IPOs. However, the 18% increase in share price may not condemn the auction process after close analysis of this unique IPO. Without having Google go public in a bookbuilding process in an alternate universe, critics cannot say decisively that the auction mechanism failed because it underpriced the offering. I would argue that had Google gone public in a traditional bookbuilding offering that the underpricing would have been more severe, and the first-day pop substantially larger than 18%.[132] This IPO generated a lot of excitement. That excitement was dampened somewhat over the summer by confusion over the mechanics of the auction process. Indeed, the mere openness of the allocation process may have reduced demand, if exclusivity can increase price. If the confusion and the media negativity surrounding the auction process were taken out of the equation, Morgan Stanley and CSFB would have marketed Google and pre-allocated the bulk of the IPO shares to regular customers and institutional investors. The hordes of other investors that wanted in on the Google IPO would have bought in the aftermarket, driving the price much higher than the offering price, generating an extremely nice profit for the institutional investors and regular customers of Morgan Stanley and CSFB. A more enlightened debate would compare Google's 18% first-day price increase with the first-day pops for similarly popular technology IPOs, even in the post-bubble climate, such as shopping.com's October 2004 IPO, which resulted in a first-day increase of 50 percent.[133] In addition, Dreamworks Animation SKG, the animation studio behind *Shrek* and *Shrek2*, launched a November 2004 IPO and saw its share price increase 38 percent on the first day of trading.[134]

[131] *Id.* at 21 ("Only a small number of initial public offerings have been accomplished using auction processes in the U.S. and other countries, and none on the scale of our offering. We expect our auction structure to face scalability and operational challenges.").

[132] Pete Barlas, *Many Thumbs Neither Up Nor Down For Google's Auction IPO*, INVESTOR'S BUS. DAILY, Aug. 27, 2004, at __ (quoting Jocely Arel, co-chairperson of Testa, Hurwitz & Thibeault as noting that "[t]he bump was significantly less than what we saw in the 1990s where some of the gains were in excess of 200%).

[133] *See* Michael Brush, *IPOs Return to Make the Rich Richer – Again*, MSN Money (Nov. 10, 2004), available at http://moneycentral.msn.com/content/P92944.asp.

[134] *See id.*

However, a more cynical explanation could also be offered for the price increase. With hours left in the bidding process, Page and Brin not only drastically lowered the price range, with the resulting $85 per share being 58% of the highest suggested $135 price, but they also reduced the number of shares that they personally would sell at that price. Instead, they were able to sell shares 180 days later at a much higher price, once they shrank the supply. In a traditional bookbuilding offering, the investment bank can manipulate the price to ensure that certain parties capture part of the demand curve. Here, Google insiders may have manipulated the price to do the same thing. Most participants agree that there were not enough bids on August 18 to allocate all the shares at $135. However, the end result of the Google auction was that bidders received 75% of their bids, strongly suggesting that the shares were oversubscribed at $85 and that the clearing price was more than $85.[135] These facts seem consistent with the argument that the shares were underpriced intentionally. In fact, Page and Brin have been able to time the sale of their stock to coincide with share price increases. Although they could not possibly have predicted that the share price would increase to almost $300 in June 2005, the founders were able to sell shares worth over $100 million each at that time, about 3 ½ times the value they would have received if they had sold the same shares in the August IPO.

In any event, the end result may be preferable to the bookbuilding system. The optimal system would capture demand for the benefit of the issuer, not the founders, but perhaps only incremental change is available here. Although the public would love to see more power in the hands of retail investors, any movement away from the traditional bookbuilding process that puts all power into the hands of the investment banks and their institutional investor friends has to be a move in the right direction.

C. *Did the Auction Create a Democratic Allocation?*

The Google auction far exceeded a traditional bookbuilding IPO in terms of retail investor participation. Even though Google did not disclose the names of the lucky successful bidders, most commentators agree that substantially more retail investors were granted original IPO shares than in bookbuilding auctions.[136] However, full retail investor participation was not realized because of screening procedures, the complexity of the auction process, and lack of retail investor access to real financial information regarding the issuer.

The Google auction appeared accessible to everyone by the third amendment to the registration statement. If you could open an account at Ameritrade or E*Trade with $2000 and bid for five shares, then you could be a Google shareholder. However, buried in the 211-page prospectus

[135] Red Herring article.

[136] *See* Michael J. Martinez, *Getting in on Google: Was It All Worth It?*, NORTH COUNTY TIMES, August 25, 2004, at __.

were two sentences:

> Because each of the brokerage firms makes its own suitability determinations, we encourage you to discuss with your brokerage firm any questions that you have regarding their requirements because this could impact your ability to submit a bid. For example, while one of our underwriters may view a bid for 100 shares at $121.50 per share as suitable for an investor, another of our underwriters could determine that such a bid is unsuitable for that same investor and therefore, not submit the bid in the auction.[137]

Online investment banks such as Ameritrade required investors to fill out an online suitability questionnaire, and reportedly many investors at several brokerage houses were rejected as unsuitable. The questionnaire asked registrants for information about financial stability, investment knowledge, and investment experience. Although many individual investors were able to bid for Google shares, many were screened out of the process.[138]

In addition, some larger brokerage houses had large minimum account balances; for example, Fidelity required a $100,000 minimum balance. Unnamed other banks required a $200,000 balance or a $500,000 balance.[139] The largest retail brokerage, Merrill Lynch, had dropped out of the IPO; had Merrill Lynch been a part of the syndicate, then individual participation may have been increased.[140]

As stated before, the process of registering for a bidder ID number at a Google website and then registering for an account at a separate broker may have been technologically too burdensome for some retail investors.[141] Moreover, the assiduousness required of bidders to be available electronically to change bids, confirm bids, and accept shares may also of frightened some retail investors away.

In addition, retail investors suffered more subtly by receiveing a barrage of information on

[137] Google, Inc., Amendment No. 5 to Registration Statement (Form S-1), at 42 (Aug. 9, 2004).

[138] *See* Calvey, *supra* note 127, at __.

[139] *See* Barlas, *supra* note 132, at __.

[140] *See* Richard Waters, *Low Turnout for Google's IPO Democracy*, FT.com (Aug. 19, 2004).

[141] *See* Barlas, *supra* note 132, at __.(citing a former chief economist for the SEC as saying that the web-based system was too confusing for individual investors due to its unwieldy interface). *But see* Jason Draho, *The Google IPO: What Happened and Why?*, vcexperts.com (last visited March 30, 2005) (presenting the counter argument that the Google auction, while an *uncertain* process, was no more of a *confusing* process than an eBay auction).

the auction mechanics but a mere trickle of information on Google financials. The instructions on bidding required pages and pages of text in the prospectus, compared with relatively little financial information that retail investors received. As in ordinary IPOs, only institutional investors, some investment banks, and a few individuals were invited to the road shows, where detailed financial information is shared by the underwriters. Not only were most individual investors not invited to the road shows, but even institutional investor managers complained that very little information was shared in the Google road shows. Allowing access and allowing informed access are not the same.

D. Did the Auction Open the Door for Other IPO Auctions?

1. Only Google Has the Market Power to Buck the System

The Google IPO was a promising breakthrough in the market for IPOs in that the company proved to the investment banks that it could engage in an IPO on its terms and according to its rules. Google did not rush to market during the technology boom and came to the negotiating table as a seasoned company with some power. Unlike many start-ups, Google did not have to court investment banks or rely on VC relationships to make introductions. Because of this power, Google was uncommonly able to determine unilaterally who would underwrite the IPO and how the IPO would proceed.

However, this does not then mean that all start-up companies will now be able to follow in Google's footsteps. Most start-ups do not have the ability to create their own IPO buzz and must rely on investment banks and their brokers to market their shares to investors.[142] Google's IPO was unique in that the issuer combined the auction platform with the support of traditional investment banks.[143] Other auction IPO users have had the support of only one underwriter, Hambrecht + Co. In addition, smaller companies will not have the clout to negotiate negotiated rates among investment banks, like Google did.

2. Google does provide a blueprint for others, including Morningstar

As one commentor noted, the Google auction could open up IPOs to retail investors in the

[142] *See Google's Dutch Treat*, *supra* note 45, at __ ("Less glamorous firms will still have to rely on the traditional investment-banking road shows to drum up investor interest – and pay the big banking fees."

[143] The investment banks did support the offering by providing marketing support, but their inexperience with the auction model may have contributed to pricing problems. *See* Choo, *supra* note __, at 423 ("These app misteps in the public eye may reflect a level of inexperience with the Dutch auction IPO model, not only on the part of Google management, but also by the investment banks.").

same way that online brokerage firms opened up investing in individual stocks.[144] The Google auction could be another example of how the Internet creates transparencies, increases access, and reduces transaction costs through increased information and elimination of fee-grubbing middlemen.

One legacy of the Google auction is that the business world knows now that Google's auction proved that the online auction is realistically viable. Many investors are willing to participate in an online auction, particularly if the auction mechanism is simplified. In addition, institutional investors may be more eager to participate in future auctions after boycotting the Google auction and having to buy at higher, post-IPO prices. Observers also learned that the process is not doomed to fail technologically. No bids were lost or ignored; the auction platform did not crash. Any technological qualms regarding the online auction mechanism should be eased by the Google auction.

Since the Google auction, only two companies have gone public using an online auction; BofI Holding, Inc. went public in March 2005 using Hambrecht's OpenIPO system.[145] BofI is a small, profitable company, and its $25 million IPO was tiny compared to the Google auction. Although BofI looked like a good investment, the company actually had to fight against a negative perception of the auction system.[146] Unfortunately, Wall Street continues to believe that immediate aftermarket demand is the sign of a good IPO. When auctions work, there is no share price increase and no excitement from Wall Street; when auctions are underpriced, such as the Google auction, Wall Street reacts by calling the auction a "Dirty Dutch" auction. Issuers in an auction almost have a no-win situation.

Interestingly, Morningstar, Inc., an investment research firm, was the second company to launch an online IPO after the Google auction. Morningstar, who had announced its upcoming IPO in May 2004,[147] reportedly had a falling out with its traditional underwriters, Morgan Stanley,[148] and then announced that it had chosen W.R. Hambrecht as its underwriter and would conduct an OpenIPO auction.[149] Morningstar also announced that it would pay discounted investment banker

[144] *See Google's Dutch Treat*, *supra* note 45, at __.

[145] www.openipo.com.

[146] Red Herring article.

[147] Morningstar, Inc., Registration Statement (Form S-1) (May 6, 2004).

[148] Steve Gelsi, *Morningstar Boosts W.R. Hambrecht*, cbs.marketwatch.com, Jan. 10, 2005 (last accessed March 30, 2005).

[149] Morningstar Inc., Amendment No. 1 to Registration Statement (Form S-1), at 105-14 (March 16, 2005).

fees of 4%, as compared to the traditional 7%. The Morningstar auction continues to lend more credibility to the auction mechanism. Unlike other issuers that have used the auction process, Morningstar is a traditional, seasoned company that is not tied to the technology sector. To have a financial services firm with ties to Wall Street abandon the bookbuilding system in favor of an online auction sends a different type of signal. In addition, Morningstar's auction avoided the problems that the Google auction encountered. All bidders registered at Hambrecht + Co., and were required only to have a balance of $2000. The $140 million Morningstar IPO is by far the largest IPO that Hambrecht has handled as lead underwriter.

V. The Future of IPO Auctions

A. *Google's Unique Auction is Not Representative*

Unfortunately, Google does not make a perfect poster child for auctions, either pro or con, because of Google's uniqueness as an issuer.[150] Among other characteristics, the Google offering was one of the largest in U.S. history. Although Google had inherent advantages in the auction process as a well-known company with marketing clout, Google's auction has also had some inherent disadvantages that would not exist in other IPO auctions. Because of Google's household familiarity, and strong following among both the technologically sophisticated and the technologically unsophisticated, Google's auction had to be engineered to handle both high volume and high interest. This "frenzy factor" is not present in most auctions. Many bidders were merely interested in obtaining shares of Google for the intrinsic value of being able to say that they obtained the shares.[151] The value of Google IPO shares was in that way the fundamental value of the company *plus* the relational utility value of participating in a once-in-a-lifetime event. Most IPOs are not events in that same way. For example, the Morningstar registration statement contained three benign risk factors associated with the auction process, compared to the nine risk factors listed in the Google registration statement.[152] Morningstar did not list as risks the possibility that large numbers of unsophisticated investors who are "less price sensitive" will drive the stock price above the price that sophisticated investors would pay.

[150] Jason Draho, *The Google IPO: What Happened and Why?*, vcexperts.com (last visited March 30, 2005) ("[I]t is important not to infer too much from the IPO on how well auctions work because it truly was a one of a kind event.").

[151] Knowledge Wharton, *Lessons From Google's IPO*, Altassets.com (last visited March 30, 2005).

[152] Amendment No. 3, *supra* note 129, at 16 ("Potential investors should not expect to sell our shares for a profit shortly after our common stock starts trading. . .Some bids made at or above the IPO offering price may not receive an allocation of shares. . . .Potential investors may receive a full allocation of the shares they bid for if their bids are successful and should not bid for more shares than they are prepared to purchase.").

B. *Opening up the road show – Another necessary aspect of democratizing IPOs*

Although the auction format may create physical access to IPOs for retail investors, as long as road shows are closed to institutional investors and select large investors, then even auction IPOs are not truly accessible to everyone at the same level. Retail investors are at a disadvantage bidding against institutional investors with substantially greater access to company information. However, the SEC has made some movement to allow road shows to be delivered electronically to all interested parties.[153] This simple change could improve individual investors access to IPOs generally, although some critics have charged that issuers and underwriters will always be able to give superior information to favored investors.

The unlimited potential of the Internet in distributing information to potential investors regarding upcoming securities offerings[154] eliminates many practical barriers to opening the traditionally exclusive road show to any interested investor. In fact, the SEC has issued several no-action letters that permit issuers to transmit live road shows via the Internet.[155] The SEC has allowed both live and on-demand presentations to be viewed over the Internet and have also allowed formats that allow viewers to submit textual questions during the live presentation that may be answered.[156]

[153] Raymond Hennessey and Phyllis Plitch, *IPO Outlook: SEC Proposes Increasing Role of Web in IPOs*, WALL. ST. J., Jan. 3, 2005, at C4.

[154] One of the first issues that arose concerning the intersection of securities offerings and the Internet was whether certain written materials, such as a preliminary prospectus, final prospectus, and even annual statements, could be posted on the Internet or delivered to recipients via the Internet. *See* Use of Electronic Media for Delivery Purposes, Exchange Act Release No. 7233, 60 Fed. Reg. 53,458 (Oct. 6, 1995). In addition, the Internet also allows for direct communication between the issuer and the public regarding the company, the company's future offerings, current registered securities, and relevant markets, thus creating the potential for violating securities laws via statements, including hyperlinks, on a company's website. *See* Use of Electronic Media, Exchange Act Release No. 33-7856, 65 Fed. Reg. 25,843 (April 28, 2000) [hereinafter "SEC Release 7856"].

[155] *See, e.g.*,1999 Charles Schwab Letter, *supra* note 99 (later qualified by Charles Schwab & Co, Inc., 2000 WL 146586 (S.E.C. No-Action Letter) (Feb. 9, 2000); Activate.net Corporation, 1999 WL 739423 (S.E.C. No-Action Letter) (Sept. 21, 1999); Thomson Financial Services, Inc., 1998 WL 575139 (S.E.C. No-Action Letter) (Sept. 4, 1988); Net Roadshow, Inc., 1998 WL 40252 (S.E.C. No-Action Letter) (Jan. 30, 1998) (regarding the transmission of road shows via the Internet to "qualified institutional buyers" in a Rule 144A offering); Bloomberg L.P., 1997 WL 739085 (S.E.C. No-Action Letter) (Dec. 1, 1997); Net Roadshow, Inc., 1997 WL 555935 (S.E.C. No-Action Letter) (Sept. 8, 1997).

[156] *See* 1999 Activate.net Letter, *supra* note 373, at *2 (describing how streaming technology would allow viewers to transmit questions to the underwriter and the issuer to be answered in the order received). Note that Activate.net is a third-party vendor that provides Internet services to multiple underwriting firms, similar to other companies asking for no-action status for providing electronic road

However, the SEC has so limited the audience for these road shows that the end result is continued exclusion of most retail investors.[157] To date, the SEC has only approved the use of electronic road shows to a set of investors virtually identical to "qualified investors who would customarily be invited to attend a traditional road show,"[158] not the general public.

One lingering regulation barrier to making electronic road shows generally accessible is the preclusion of written communications by the issuer during the quiet period before a registration statement is effective. Although face-to-face road shows have been allowed as oral communications during the quiet period, the S.E.C. has not abandoned the written/oral distinction in the face of Internet technology. In allowing videotapes to be shown to visitors on closed-circuit televisions, the party seeking no-action status had distinguished videotaped material shown to a directed audience from radio and television programs that are broadcast to the public at large and had extended that analysis to taped road shows shown on the Internet to selected viewers.[159] This interpretation also allows for Internet transmission of road shows to a select group of investors while avoiding a substantial revision of § 2(a)(10). However, obtaining regulatory approval for a road show that would be accessible by any interested investor will require the S.E.C. to, at a minimum, deem

shows, such as Private Financial Network, Thomson and Bloomberg. This fact suggests that the rise in electronic road shows was not reflective of a desire to make road shows more accessible to the retail investor but of a profit-seeking motive of vendors looking for a new product.

[157] *See, e.g.*, 1999 Charles Schwab Letter, *supra* note 99, at *4 (indicating that road shows will only be accessible to investors with accounts at the "Schwab Signature ServicesTM Gold level or above). Although the Schwab 1999 Letter contains a persuasive call for the SEC to open up the road show to as many retail investors as possible, the group for which access was sought in 1999 comprised institutional investors and retail investors who either executed 24 trades a year with Schwab or invested $500,000 in equity positions with Schwab. *See id.* at *4 n. 1.

[158] 1999 Activate.net Letter, *supra* note 373, at *3 (describing this set of participants as "institutional investors, securities firms, trading and sales personnel from participants in the offering and research analysts"); *see also* Thomson 1998 Letter, *supra* note 373, at *2 (noting the condition that "the viewer is an institutional investor or other person of a type the underwriter would customarily invite to a road show"); Net Roadshow 1998 Letter, *supra* note 373, at (regarding the transmission of road shows via the Internet to "qualified institutional buyers" in a Rule 144A offering); Bloomberg 1997 Letter, *supra* note 373, at *2 (affirming that "a viewer would not be able to receive the transmission unless the viewer [was] an institutional investor, investment adviser or other person of a type the underwriter would customarily invite to a road show"). *But see* 1999 Charles Schwab Letter, *supra* note 99, at *4 (claiming that making road shows available to customers in Schwab's Gold level or above would be vastly improving access to the retail investor).

[159] *See* Private Financial Network, 1997 WL 107175 (S.E.C. No-Action Letter) (Mar. 12, 1997) (citing In Exploration, Inc., 1986 SEC No-Act. LEXIS 2891 (Nov. 10, 1986) and Producers Funding Corp., 1982 WL 30515 (S.E.C. No-Action Letter) (Mar. 9, 1982).

Internet video communications to be oral and not written.[160] A more comprehensive solution[161] would be to deregulate both oral and written communications during the quiet period,[162] thus eliminating the asymmetry of information that results between large investors who can meet face-to-face or telephonically with an underwriter and the public at large with no such access.

C. *The Status Quo*

Unfortunately, the important players in the market for IPOs, the investment banks and the institutional investors, have a vested interest in criticizing the Google IPO and in having the online IPO auction concept disappear.[163] The withdrawal of Morgan Stanley from Morningstar's IPO after Morningstar decided to use an auction format is symbolic of traditional investment bank disdain of the process. Without investment bank support in marketing and research both before and after the IPO, few issuers will be brave enough to be IPO auction pioneers.

VI. Conclusion

For some, the Google auction is like Harry Potter's mirror at Hogwarts that shows the observer what the observer wants to see. Those critics who denounce IPO auctions and defend bookbuilding as the best method of getting IPO shares into the hands of the most valuable investors see the Google auction as a failure. The auction offering price underpriced market demand, and Google left money on the table. Google scared off both institutional investors and retail investors with its confusing auction process and regulatory missteps. On the other hand, auction supporters see the Google auction as a necessary first step to public acceptance of the auction method. To

[160] *See* Brian J. Lane, Views into the Crystal Ball, Address before the Committee on Federal Regulation of Securities, American Bar Association (Nov. 13, 1999), *available at* 1999 WL 1399912 (S.E.C.) (noting cynically concluding that Internet road shows could easily be deemed to be oral statements because "the Bar appears to be comfortable in making judgments about whether something is a writing").

[161] *See* Laura S. Unger, Technology and Regulation: The Road Ahead, Address before the San Diego Securities Institution (Jan. 27, 2000), *available at* 2000 WL 132740 (S.E.C.), at *4 (noting that the S.E.C. staff seemed to be able to go no further at opening up road shows through no-action letters given the existing regulatory framework).

[162] *See* Laura S. Unger, *Raising Capital on the Internet*, 69 U. CIN. L. REV. 1205, 1208 (2001)[hereinafter *Raising Capital*] (reasoning that eliminating the distinction between oral and written communications would also facilitate e-mail communications between underwriters and investors).

[163] Draho, *supra* note 150, ("The apparent highly profitable collusion that goes on between these two groups in bookbuilt IPOs at the expense of issuers and retail investors obviously implies that they have an interest in maintaining the status quo.")

some, the auction succeeded merely because retail investors who had never had the chance to participate in an IPO received original IPO shares. In addition, if the share price was underpriced, the underpricing was negligible compared to underpricing that could be expected of such an IPO in the hands of Wall Street investment bankers.

Because of the idiosyncratic nature of the Google auction, the lessons that can be learned for future issuers are limited. However, with each additional issuer that uses an auction format, such as Google and now Morningstar, the format become incrementally more acceptable. At some point, the auction mechanism could become sufficiently viable as an alternative to issuers and force Wall Street to create a complementary product to OpenIPO.