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Market Structure Issues and Impact on IPOs

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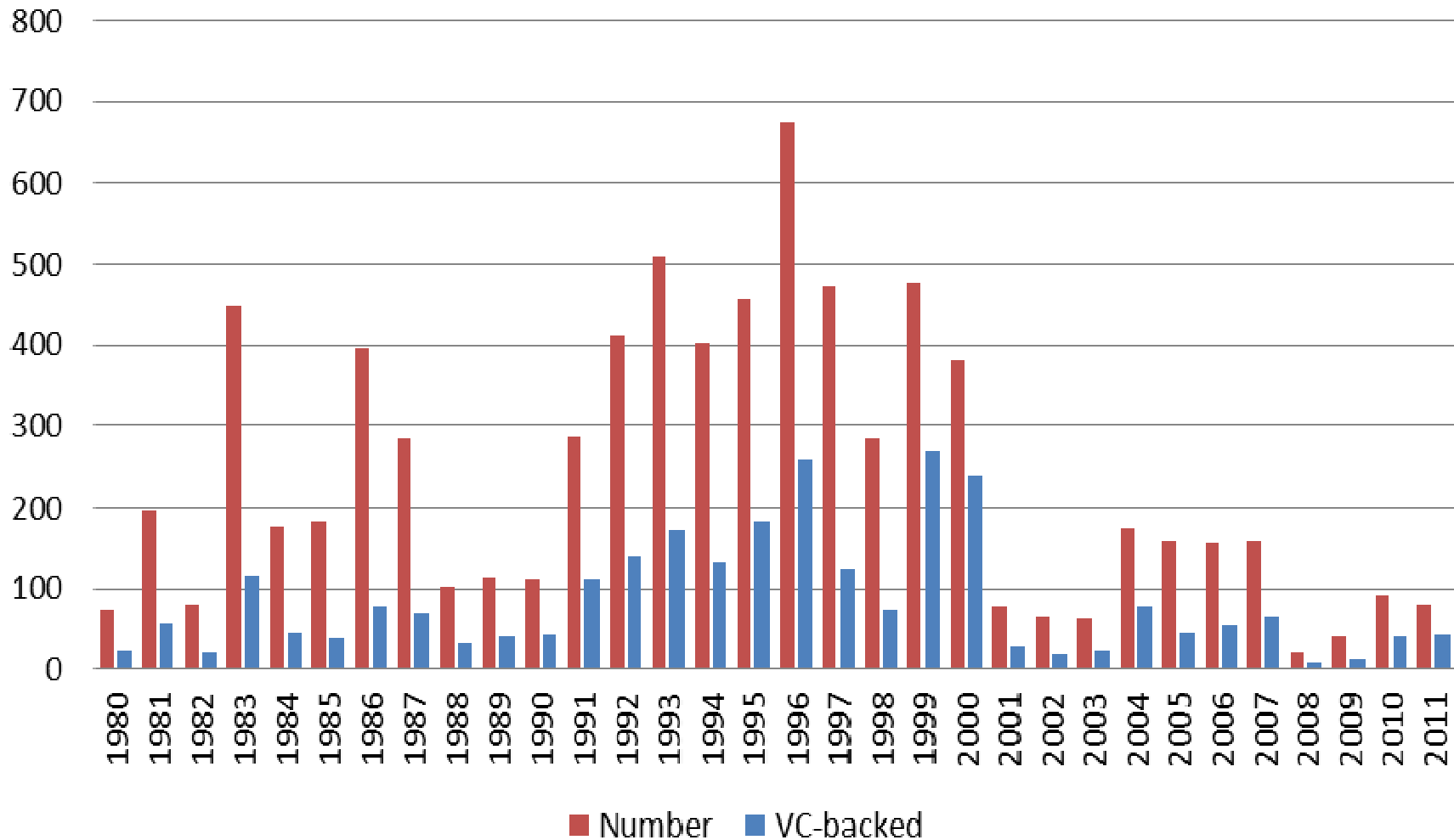


Overview—Dearth of IPOs

- Nasdaq Bubble bursts in 2000
 - Disproportionate effect on retail investors
- Demographic shift
- Poor long-run (3 year) performance
- High profile IPO investigations
 - Laddering
 - Spinning
 - Commissions
- Increased regulatory burden
- Concurrent tick size changes

IPO Activity 1980-2011

Jay R. Ritter, 2012, "Initial Public Offerings: VC-backed IPO Statistics Through 2011"



Poor 3-year returns

Jay R. Ritter, 2012, "Initial Public Offerings: VC-backed IPO Statistics through 2011"

	1980s	1990-98	1999-2000	2000s
Buy and hold	22.6%	39.4%	-53.3%	13.1%
Market adjusted	-22.6%	-21.3%	-31.9%	2.0%
Market Adjusted				
VC-backed	-12.4%	-1.9%	-41.5%	-8.4%
Others	-26.1%	-31.4%	-17.9%	8.0%

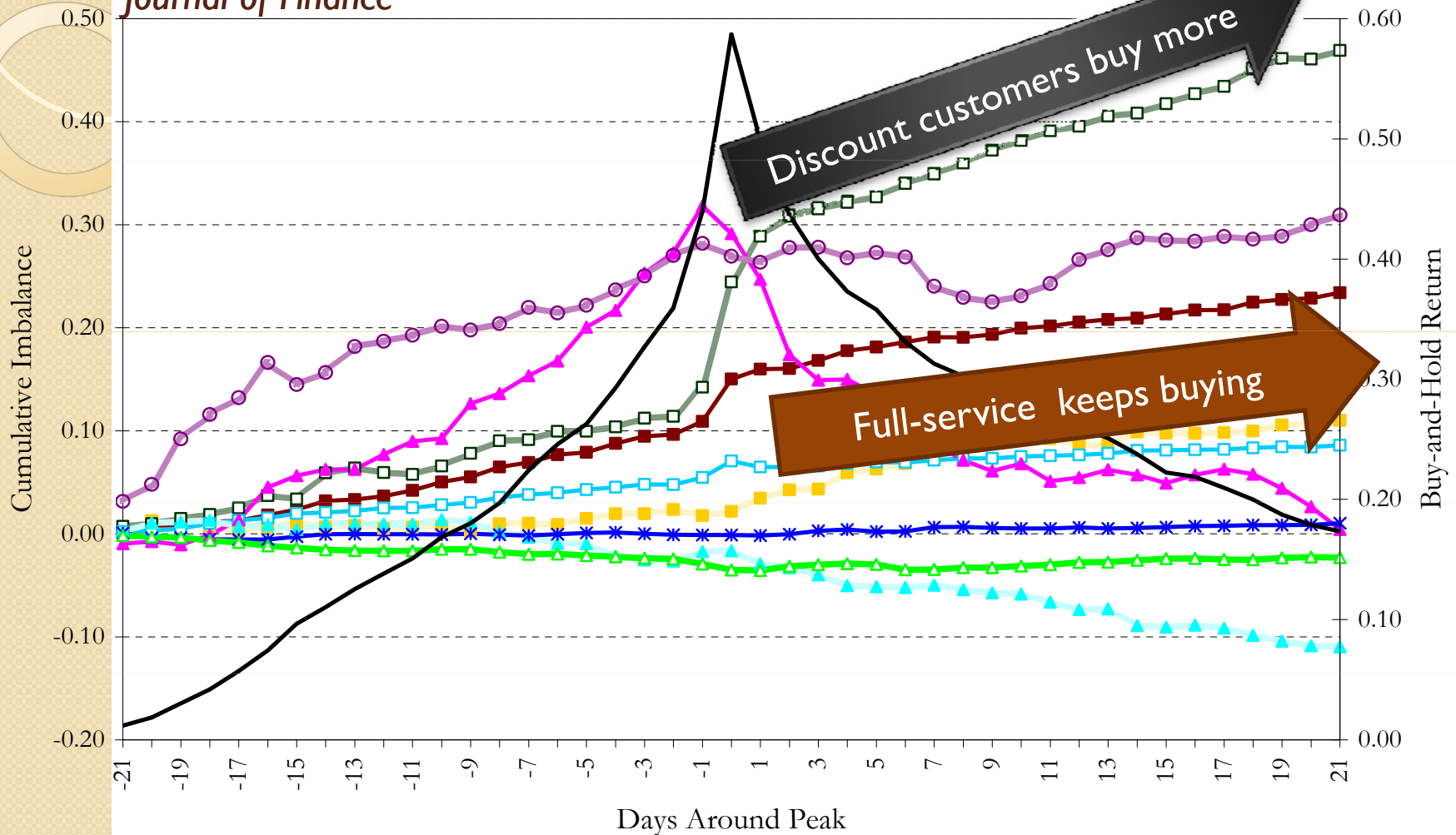
Poor 3-year returns, by size

Jay R. Ritter, 2012, "Initial Public Offerings: Tables Updated through 2011"

Sales	Raw	Market Adjusted
<10MM	-10.8%	-47.3%
10-20MM	5.2%	-36.7%
20-40MM	21.3%	-22.3%
50-100MM	38.4%	-3.9%
100-500MM	39.2%	-2.9%
>500MM	36.7%	2.6%

Burned by the Nasdaq Bubble

Griffin, Harris, Shu and Topaloglu, 2011, "Who Drove and Burst the Tech Bubble?," *Journal of Finance*



- Individual General
- ▲ Institutional
- Mixed
- Individual Full-Service
- ▲ Largest Ibanks
- Buy-and-Hold Return
- Individual Discount
- * Hedge Fund
- Individual Daytrading
- ▲ Derivatives



Public Perceptions

- Investors buy access to initial day IPO returns
 - *Commissions*—Dole out IPOs to active traders or charge higher commissions on other trades
 - *Laddering*—UW requires investors to buy secondary shares
 - *Spinning*—UW allocates hot IPOs to executives' personal accounts to win underwriting business
- *Analysts Conflict of Interest*
 - Make “buy” recommendation (while the investment bank sells shares) in return for future business

Commissions and Laddering

- VA Linux IPO rises from \$30 to \$239.25 on first day
 - CSFB charges \$0.50 to \$2.75/share to a customer (trading Kroger, AT&T, Compaq, etc.)
 - Normal commissions \$0.03 to \$0.06/share

Source: SEC's Jan. 22, 2002 settlement with CSFB

- **Laddering: Allocate shares to investors who agree to buy more in the aftermarket**
 - 1997-2002 IPOs, 9% excess demand through lead UW
 - From larger traders
 - From short-term traders
 - Through more active UWs,
 - Despite more costly executions
- Griffin, Harris and Topaloglu (2007)

Spinning: Bernie Ebbers and WorldCom

IPO	Date	Ebbers' shares	IPO Price	Price at 1 st day close	Profit (1 st Day)
McLeod	7/96	200,000	\$20	\$25.13	\$1,026,000
Qwest	6/97	205,000	\$22	\$28.00	\$1,230,000
NextLink	9/97	200,000	\$17	\$23.25	\$1,077,300
Metromedia	10/97	100,000	\$16	\$21.38	\$538,000
Rhythms	4/99	10,000	\$21	\$69.13	\$481,300
Juno	5/99	10,000	\$13	\$11.63	-\$13,700
Williams	10/99	35,000	\$23	\$28.03	\$177,000
KPNQwest	11/99	20,000	\$20.81	\$29.81	\$180,000

+ 13 more IPOs with \$700,000 in additional profits
 Total (One Day!) Profits approximately \$5.3 million

The Hangover

- Retail investors burned disproportionately by the bubble
 - Moreso for discount brokerage accounts
- Relatively poor longer-term returns
 - Worse for smaller IPOs
 - No longer a secret
- Public reluctance
 - High profile scandals
 - Is deck stacked against the retail trader?



Competition for IPO investment dollars

- Bonds
- ETFs
- Mutual funds

- Real estate
- Commodity funds
- Private equity funds



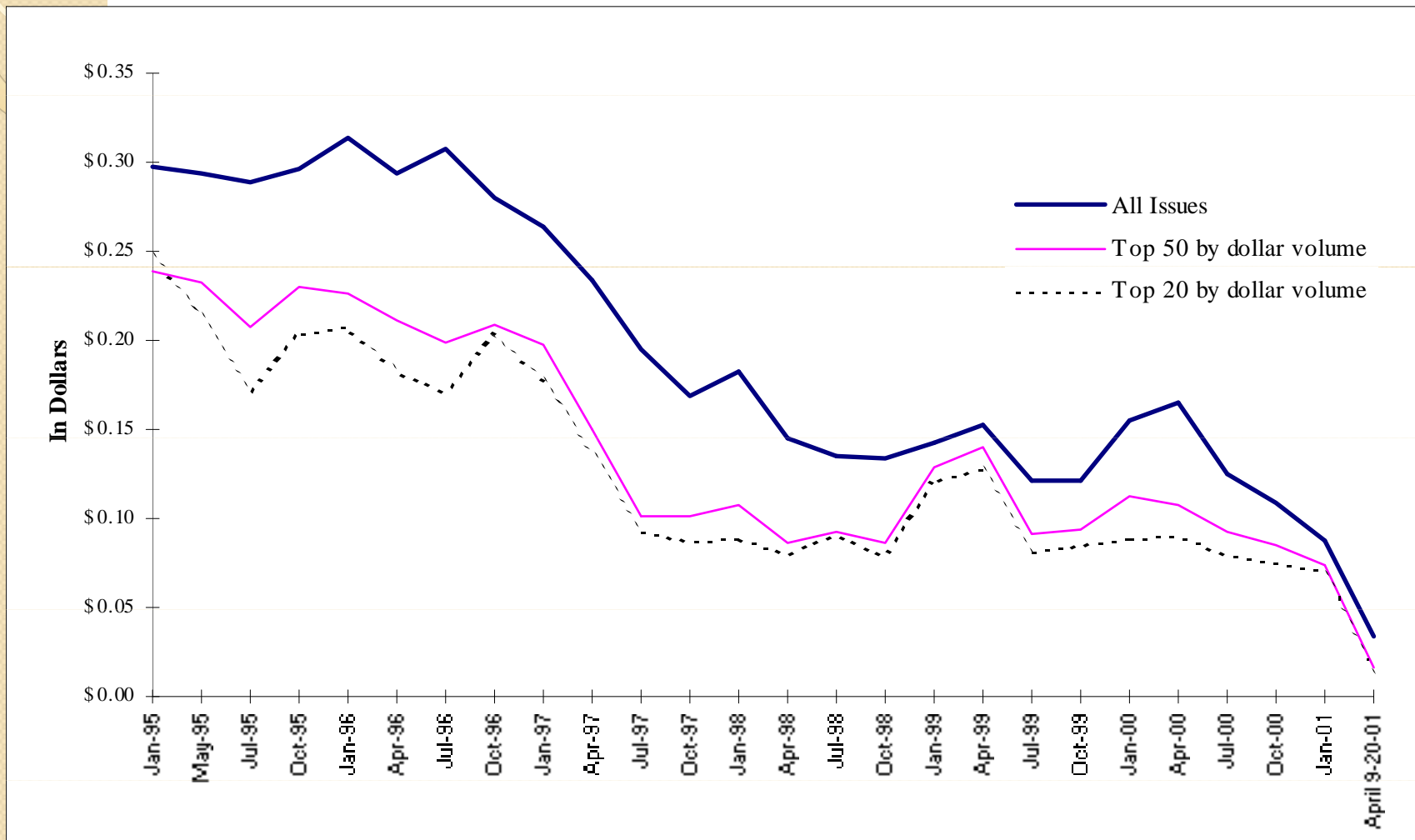
Market Structure Issues

- Market structure can enhance participation
 - Easley and O'Hara (2010)
- Fewer IPOs when
 - Listing fees are high
 - Other fixed costs are high (Sarbanes-Oxley)
 - Perceived difference between sophisticated and retail investors is high
 - Potential IPOs are small

Decimalization and Declining Spreads

- Incentives to promote stocks
 - Brennan and Hughes (1991) Relative tick size enhances brokerage commissions
 - Angel (1997) Optimal relative tick size enhances market making profits
 - Schultz (1999) Empirical support
- Spreads have dropped precipitously
 - \$0.30 in 1995
 - <\$0.05 in 2001

Nasdaq Volume-weighted Quoted Spreads (1995-2001)





Rebooting the IPO market

- Reduce fixed costs
 - Sarbanes-Oxley revisited?
 - 1994 OTCBB disclosure rules revisited?
- Reassure retail investors

 - Enforcement/penalties?
 - Settle on rules/reduce ambiguity
- Engage with VCs
 - Resurgent VC investment stifled by crisis?
- Incentives to promote stocks
 - Paying liquidity providers
 - Anand, Tangaard and Weaver (2009)



Thank You!

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