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BUILDING A BETTER BOOKBUILDING SYSTEM – AN EXAMINATION OF THE UK'S BOOKBUILDING REGIME AND PROPOSED REFORMS

Tong Jing Lim[*]

Abstract: In 2013, shares of the UK Royal Mail were underpriced by an average of approximately nine percent per share, resulting in the government making £180 million less than it could have at the time of the initial public offering (IPO). Although the 2014 independent review by Lord Myners claimed that a price near the levels seen in the aftermarket could not have been achieved at the time of the IPO, the Myners Report acknowledged that the current price formation process in the UK is not perfect, and that improvements must be made. This paper examines the current UK price formation process and argues that, notwithstanding its flaws, the present bookbuilding system should not be replaced by an auction system as advocated for by the Myners Report. Rather, this paper submits that bookbuilding should be retained in light of its significant advantages, albeit with certain regulatory amendments that this paper proposes to improve the price formation process.

A. INTRODUCTION

In 2013, shares of the UK Royal Mail were underpriced by an average of approximately nine percent per share, resulting in the government making £180 million less than it could have at the time of the initial public offering (IPO).[1] Although the independent review by Lord Myners (the Myners Report) claimed that a price near the levels seen in the aftermarket could not have been achieved at the time of the IPO, the Myners Report acknowledged that the current price formation process in the UK is not perfect, and improvements must be made.[2] Accordingly, this paper seeks to analyse the current UK price formation process. Notwithstanding the flaws of the bookbuilding process, it is submitted that bookbuilding should not be replaced by auctions, as advocated instead in the Myners Report.[3] Rather, bookbuilding should be retained in light of its significant advantages, albeit with certain regulatory amendments that this paper will propose to improve the price formation process.

This paper extends the current literature, which has largely focused on pricing mechanisms in the US and European countries, by specifically examining the UK's price

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[1] David Parker, 'Selling the Royal Mail' (2014) 24(4) Public Money & Management 251, 254.
[2] Paul Myners, 'An Independent Review for the Secretary of State for Business, Innovation & Skills: IPOs and Bookbuilding in Future HM Government Primary Share Disposals' (BIS 2014) 7.
[3] ibid 57.

formation process. Whilst most of the literature provides an economic perspective of the price formation process, this paper provides an additional dimension by presenting an analysis from both an economic and legal point of view. The analysis is timely, given the publication of the 2014 Myners Report,[4] as well as the ongoing market survey conducted by the UK Financial Conduct Authority (FCA),[5] both of which seek to review the current price formation process in the UK.

This paper begins by providing an overview of the UK IPO and price formation process. Following this, Section B analyses the benefits present in the current bookbuilding mechanism. Section C continues the analysis by identifying the problems associated with the UK bookbuilding system. In particular, it focuses on conflicts of interest that may arise during the bookbuilding process. Throughout both Sections, comparisons are drawn with an auction system where appropriate. Finally, Section D proposes regulatory reforms in the area of bookbuilding and Section E draws some conclusions.

1. *Overview of the IPO process*

The IPO market, also known as the primary market, is a platform where companies offer shares to the public on a stock exchange for the first time. A company goes public for various reasons. Most obviously, an IPO provides the company with access to capital growth, giving them the ability to raise funds, either at the time of flotation, or later, to reduce gearing, raise working capital or to fund acquisitions and new initiatives. An IPO also heightens the company's public profile, which helps to attract customers in product markets. Other benefits of an IPO include increased liquidity with public securities, which provides greater scope for the company to offer employees remuneration packages including shares and options, hence encouraging employees' commitment.

The IPO process can be divided into four phases.[6] The first phase involves organising and identifying the motives and goals for going public. The second phase deals with pre-IPO preparations. This includes the appointment of advisors, negotiations, due diligence, valuation of assets and preparation of marketing materials. The next phase is the marketing phase. Both pre-marketing (which is applicable in some countries) and the price formation process are central to the marketing phase. There are three types of pricing mechanisms: fixed-price offerings, standard auctions, and the bookbuilding. In the last phase, also known as the closing

[4] Myners (n 2).
[5] Financial Conduct Authority, 'Investment and corporate banking market study: Terms of reference' (FCA 2015).
[6] Juan Ramirez, *Handbook of Corporate Equity Derivatives and Equity Capital Markets* (Wiley 2011) 68.

period, the prospectus and the offer price are finalised, and allocations of shares take place before the offering is finally placed on the stock exchange and an IPO/flotation takes place. The price formation process is key to the IPO. From the company's (also known as the issuing firm) perspective, the process is crucial as it determines, among other things, if an optimal initial offer price could be attained. A high initial offer price allows the company to raise more capital without the need to issue more shares, which would reduce the stakes held by existing shareholders. At the same time, the offering should not be mispriced or overpriced, and the initial offer price should be set at a small discount to the future market price in order to generate sufficient interest and demand in the shares. In addition, factors other than price, such as shareholder base and initial discounts, may also be important objectives. From the market and the regulators' perspectives, attaining an appropriate offer price is fundamental to a deep and liquid market. Importantly, the price formation process should also fulfil general market objectives to be 'fair, efficient and transparent'.[7] In other words, a well-functioning price formation process should be one that guards against improper trading activities and allows investors fair access to market facilities, markets, and price information. An optimal price discovery in the price formation process is also essential to attain market efficiency. Lastly, transparency is vital to realise a fair and efficient price formation process.[8]

The underwriter, which is typically an investment bank, plays a crucial role in the IPO process. The role of an underwriter includes advising the issuing firm on the type of security and its pricing, information gathering, marketing the issue to investors, and completing the necessary paperwork.

2. UK Bookbuilding

The UK price formation process starts in the pre-marketing phase. In the UK and Europe, interactions between investors and the investment bank are common. This is unlike the US, which prohibits any test-the-waters communication of an offering prior to the prospectus being approved by the Securities Exchange Commission,[9] subject to exceptions.[10] The purpose of the pre-marketing period is to aid in price discovery of fair prices for the offering, by providing indications of the initial price range. They also help to build relations with potential key

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[7] International Organization of Securities Commissions ('IOSCO'), 'Objectives and Principles of Securities Regulation' (OICV-IOSCO 2010) <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf> accessed 15 July 2015.

[8] David Lawton, 'Price: the cornerstone of markets' (International Capital Market Lecture Series 2014, FCA, 3 February 2014) <http://www.fca.org.uk/news/price-the-cornerstone-of-markets> accessed 15 July 2015.

[9] Securities Act 1933, §5(c); Securities Act Release No. 3844 (Oct 8, 1957).

[10] Eg Jumpstart Our Business Startups Act 2012, §105.

investors early on.[11] While pre-marketing can take place either through pilot fishing or anchor marketing, the UK adopts the former. The concept of anchor marketing requires a degree of commitment by key investors before the IPO is opened for public bidding. On the other hand, investors participating in pilot fishing are only required to reveal their interest (in terms of price and demand) for underwriters to gauge how the market may respond to an issue.[12] An initial offering price range will then be set on the basis of the pre-marketing feedback.

After the initial price range has been set, the official price formation process begins. Pre-Big Bang era, that is, prior to the deregulation of the London Stock Exchange, the IPO market in the UK operated mainly under a fixed offer price regime.[13] Under the regime, the issuing firm and its underwriters set a fixed offer price that will not be affected nor adjusted in accordance to demand and supply once marketing begins. However, the fixed price regime was not the most effective pricing mechanism, as IPOs under the regime suffered from severe pricing inaccuracies.[14] As a result, the UK began to experiment with the auction pricing method during the period between the late 1960s and the early-to-mid-1980s.[15] Under an auction structure, participants bid for shares in an electronic system, in which allocation principles are set down expressly and shares are allocated to the highest bidders.

Nonetheless, it was ultimately the open-price bookbuilding mechanism, rather than auctions, that was dominant in the London Stock Exchange by the 1990s. There are three main characteristics that are unique to the UK bookbuilding system, as compared to the two aforementioned pricing mechanisms. Firstly, only a few investors will be invited to participate in the bookbuilding period, which begins after the price range has been set. Secondly, the process allows underwriters, who are also known as 'bookrunners' in this process, to build a book of demand that facilitates price discovery. Lastly, and pertinent to our discussion, the final pricing and allocations of shares are largely left at the discretion of the underwriters.

B. MERITS OF THE UK BOOKBUILDING PROCESS

1. Information revelation

The present bookbuilding mechanism is efficient in facilitating primary market price discovery for a fair IPO price. Primary market price discovery refers to 'the degree to which prior

[11] Nigel Page, *A guide to listing on the London Stock Exchange* (London Stock Exchange 2010) 63.
[12] Ramirez (n 6) 76.
[13] Myners (n 2) 52.
[14] David Chambers, 'Gentlemanly capitalism revisited: a case study of the underpricing of Initial Public Offerings on the London Stock Exchange, 1946-86' (2009) 62(S1) Economic History Review 31, 36.
[15] ibid 39-40.

expectations regarding the value of the offering […] are revised in accordance to the feedback from investors and the market at large before the offer price is set'.[16] During the bookbuilding period, investors are invited to provide non-binding indications of interests at various prices within the advertised price range. Indeed, bookbuilding assumes that investors are more knowledgeable about pricing information than issuers or underwriters. Such information includes investors' own demands for the issue, inside information about a competitor that could significantly affect the prospects of the issuer and more generally, knowledge of the market's valuation of the offering. [17] Participants of the bookbuilding process are usually a select few institutional investors. Retail investors are generally excluded.

It is submitted that it is precisely this exclusion of retail investors that makes bookbuilding an efficient and accurate information-gathering process. It would be extremely inefficient, if not infeasible, for the underwriter to invite a large group of small retail investors to participate in the bookbuilding process, given the tight timeline of a typical IPO process. Furthermore, retail investors are typically less informed and less skilled at valuation when compared to professional investors. For instance, individual retail investors tend to overweigh personal experiences when making investment decisions.[18] Larger corporations are generally more resourceful. Thus, it is optimal to limit the price discovery phase to well-informed institutional investors. It is interesting to note that, based on a survey conducted by Jenkinson and Jones, the quantity of information disclosed by institutional investors does not differ significantly between the larger and smaller corporations.[19]

In addition, it is further submitted that the present bookbuilding system has the added advantage of allowing underwriters to build a book of demand that reflects the expected quantity of shares at different prices. The book distinguishes between three types of bids.[20] Firstly, investors may submit a strike bid. A strike bid allows investors to decide only on the quantity of shares to purchase, and they will have to accept any issue price up to the top of the indicative range. Secondly, investors may opt for a limit bid, whereby they indicate the maximum price that they are willing to pay for the quantity demanded. Thirdly, a step bid

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[16] Alexander Ljungqivst and Wlliam J Wilhelm, 'IPO allocations: discriminatory or discretionary?' (2002) 65 Journal of Financial Economics 167, 178.

[17] Kevin Rock, 'Why new issues are underpriced' (1986) 15(1-2) Journal of Financial Economics 187, 190; Lawrence M Benveniste and William J Wilhelm, 'A comparative analysis of IPO proceeds under alternative regulatory environments' (1990) 28(1-2) Journal of Financial Economics 173, 178.

[18] Markku Kaustia and Samuli Knüpfer, 'Do investors overweight personal experience? Evidence from IPO Subscriptions' (2008) 63(6) The Journal of Finance 2679.

[19] Tim Jenkinson and Howard Jones 'IPO pricing and allocation: a survey of the views of institutional investors' (2009) 22(4) Review of Financial Studies 1477, 1489.

[20] Page (n 11) 65.

occurs when investors submit a series of limit bids providing precise amounts of demand at different prices. Of these, limit bids tend to be the most informative, while strike bids provide the least information. It should be noted that a bidder who submitted a strike bid would not necessarily be awarded with fewer underpriced shares in the UK. This is due to the fact that the particular bidder may have revealed useful information at the earlier pre-marketing phase.

Accordingly, since the information gathered during bookbuilding will eventually be imputed in the secondary market, the bookbuilding process enables the issuer and underwriter to estimate future market prices (assuming an efficient market in which the aftermarket shares prices would fully reflect all available information).[21] Typically, the initial offer price is set at a discount to the future market price, in order to generate sufficient interest in the offering. Unlike the fixed offer price mechanism, which does not engage investors in any extensive discussion with the underwriters prior to fixing the offer price, bookbuilding invites information revelation. Consistent with this view, empirical evidence shows that UK IPOs with fixed price offerings were more heavily discounted than bookbuilt IPOs for the period of 2004-2012.[22]

Indeed, and perhaps ironically, optimal price discovery is only possible if underpricing occurs. Underpricing, which refers to the situation when the first-day closing price of an IPO stock is greater in amount/percentage than the offer price,[23] is essential in bookbuilding to incentivise informed investors to truthfully reveal positive information about the issue. In the absence of compensation for information revelation, investors would be tempted to withhold information, or actively misrepresent positive information, in order to be able to subscribe at a low offer price before subsequently selling the shares in the aftermarket at the higher full-information price (assuming an efficient capital market). Thus, a certain amount of underpricing is necessary to facilitate price discovery, particularly since information collection can be costly for investors. In fact, it has become a common market practice to compensate investors for information by underpricing, and final offer prices are often partially adjusted in accordance with new information and demand.[24] Issues with greater amount of good

[21] John Coffee and Hillary Sale, *Securities Regulation: Cases and Materials* (11th edn, Foundation Press 2009) 213.
[22] Myners (n 2) 76.
[23] Alexander Ljungqvist, 'IPO Underpricing' in B Espen Eckbo (ed), *Handbook of Corporate Finance: Empirical Corporate Finance Volume 1* (North-Holland 2007) 381.
[24] Kathleen W Hanley, 'The underpricing of initial public offerings and the partial adjustment phenomenon' (1993) 34 Journal of Financial Economics 231.

information are typically more underpriced than other IPOs.[25] Nevertheless, although underpricing results in lost potential capital for the issuer, issuers benefit from the resulting information acquisition, which provides an indication of future market prices. Paradoxically, the facilitation of price discovery helps to minimise the extent of underpricing. More specifically, underpricing that occurs within this context ranges between a low 2 percent and 5 percent.[26]

The foundation underpinning optimal price discovery and minimal underpricing is the underwriter's ability to allocate discretionarily under the present bookbuilding system. With discretionary power, preferential allocations can be used to reward truth telling. Conversely, any restrictions on the underwriter's discretion to allocate shares to more informed investors (for example, by regulating a specific portion of allocation to retail investors) may result in greater reliance on underpricing to aggregate information from less informed investors. As Ljungqivst puts it, 'underpricing all shares by $1 but skewing allocations so that co-operative investors reap most of the underpricing profits is preferable to having to underprice all shares by $2 to generate the same dollar reward for co-operative investors on smaller allocations'.[27] In other words, discretionary allocation is vital for the efficiency of the pricing mechanism and for an optimal initial offer price to be realised simultaneously.

2. *Advantages of discretionary allocation*

The underwriter's discretion on share allocation is desirable to the extent that it is used in favour of the issuer, which would allow the IPO and its final allocation to be aligned with the issuing firm's long run business objectives. For instance, the issuer may have a particular preference to spread the ownership of shares widely, for reasons associated with increased liquidity, or to retain control in the company.[28] In such a case, the underwriter can exercise its allocation discretion to favour investors who demand a smaller number of shares. The issuer may also have preferences over the nationality of its investors, depending on the nature of the issuing firm. For example, larger firms with low risks tend to prefer international investors to, inter alia, reap the price advantages of a global IPO and broaden the shareholders base.[29] Empirical

[25] Francesca Cornelli and David Goldreich, 'Bookbuilding: How Informative is the Order Book' (2003) 58(4) The Journal of Finance 1415.
[26] Jay R Ritter, 'Equilibrium in the Initial Public Offerings Market' (2011) 3 Annual Review of Financial Economics 347, 352.
[27] Ljungqvist (n 23) 390.
[28] Michael J Brennan and Julian Franks, 'Underpricing, ownership and control in initial public offerings of equity securities in the UK' (1997) 45 Journal of Financial Economics 391, 402.
[29] Susan Chaplinsky and Latha Ramchand, 'The Impact of Global Equity Offerings' (2000) 55(6) The Journal of Finance 2767, 2774.

evidence collected by Jenkinson, Jones and Suntheim also suggests that underwriters exercise their discretion to the benefit of issuers, by allocating shares to long-term investors, away from 'flippers' who are likely to depress aftermarket share prices.[30]

3. Auctions

By way of contrast, optimal price discovery is unlikely to occur in an auction system. Under the auction system, the underwriter has little or no control over pricing and shares allocation to cater to the need to compensate investors for information revelation. This leads to moral hazards and free rider problems. Moral hazard problems occur due to the presence of perverse incentives for irresponsible risk-taking.[31] This is particularly evident in the case of Dutch auctions and uniform price auctions, where bidding will only determine the final allocations and the offer price is uniform for all bidders. Consequently, new bidders will be enticed to 'free-ride' by following high bids without conducting their own valuations, on the presumption that other bidders would have collected the necessary information. The effect of free-riding by some investors means that other investors will also be less incentivised to collect information, since there will be no readily effective way of charging for free-riding. As a result, the auction pricing process becomes less efficient and mispricing occurs.

Accordingly, this paper respectfully disagrees with the position taken in the Myners Report that the use of auctions can ensure maximum price discovery. The Myners Report contends that since investors bid what they are each willing to pay and since auctions are 'more transparent', no discretionary price adjustment takes place and an auction reveals the true demand curve.[32] However, as pointed out in the previous paragraph, the information revealed in an auction system may not reflect an accurate level of future demand due to free-riding issues. In contrast, the discretion provided by the bookbuilding system can be especially beneficial for the issuing firm, provided the underwriter exercises its discretionary power appropriately. Coupled with the benefits of optimal price discovery and minimal underpricing, the bookbuilding mechanism leads to a highly efficient price formation process, and is therefore desirable from both the issuer and the market's viewpoint.

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[30] Tim Jenkinson, Howard Jones and Felix Suntheim, 'Quid pro quo? What factors influence IPO allocations to investors?' (2016) FCA Occasional Paper 15, 48; see also Tim Jenkinson and Howard Jones, 'Bids and Allocations in European IPO Bookbuilding' (2004) 59(5) The Journal of Finance 2309, 2310.

[31] Harry McVea, 'Financial Services Regulation under the Financial Services Authority: A reassertion of the market failure thesis?' (2005) 64(2) Cambridge Law Journal 413, 424.

[32] Myners (n 2) 57.

C. CONFLICTS OF INTEREST

Unfortunately, the efficiency of the price formation process may be hindered by problems associated with conflicts of interest. Whilst the aforementioned advantages of the bookbuilding mechanism assume that the underwriter's interests are fully aligned to those of the issuing firm, this is often not the case in practice due to the potential for conflicts of interest. It follows that, although the bookbuilding mechanism may be used in favour of the issuer, it can also exacerbate the inherent agency problems between the underwriter and the issuer, and hence work to the latter's disadvantage. At this point, it is important to note that the underwriter's discretionary power on shares allocation and pricing does not per se lead to conflicts of interest; rather, it is the lack of transparency associated with this discretion that is the root of the problem.

1. Conflicts of interest: underwriters and issuers

The issue of conflicts of interest is particularly problematic, as it frustrates all market objectives of fairness, efficiency, and transparency. If conflicts of interest become severe, bookbuilding will lead to excessive underpricing. In such cases, bookbuilding will cease to be the optimal route to price discovery.[33] From the issuer's perspective, conflicts of interest can be detrimental in two ways. Firstly, underpricing implies a transfer of wealth from existing owners to new investors, and that equity raising has not been maximised for the issuing firm. More specifically, Jenkinson and Suntheim suggest that the value of the IPO may be maximised to specific investor clients of underwriters.[34] Despite this, it is interesting to observe that issuers are generally less concerned with excessive underpricing, insofar as it nevertheless results in an overall increase in wealth,[35] and if underpricing is accompanied by a reputable underwriting firm.[36] Regardless, it is certain that issuing firms will not reject a situation in which underpricing is minimised (if all other factors remain constant). Secondly, misallocations of shares that result from conflicts of interest may run counter to IPO objectives, and the firm's continuing business strategy.

There are two areas of conflict in the context of bookbuilding. One potential area pertains to pricing. Ideally, underwriters ought to recommend an offer price in accordance with the information gathered during the bookbuilding process. The price will be set at a level where

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[33] ibid 55.

[34] Jenkinson, Jones and Suntheim (n 30) 48.

[35] Tim Loughran and Jay R Ritter, 'Why don't issuers get upset about leaving money on the table in IPOs?' (2002) 15 Review of Financial Studies 413, 424.

[36] Tim Loughran and Jay R Ritter, 'Why has IPO underpricing changed over time?' (2004) 33(3) Financial Management 5, 32.

demand exceeds supply,[37] in the best interests of the issuing firm, as mentioned. In reality however, this may not always occur, as a result of misalignment of interests between the underwriter and the issuing firm. Conflicts of interest may arise either as a conflict between the firm's interests and its duty to its customers (interest-duty), or due to conflicting duties owed to different customers (duty-duty).[38]

Most fundamentally, underwriters owe duties to both issuers and investors. As a result, they are often required to strike a balance between both parties' desires to achieve profit maximisation, as reiterated by the FCA,[39] through high offer prices for issuers and underpriced shares for investors (ie duty-duty conflicts of interest). Since the underwriter has to be accountable to both parties, alongside the lack of transparency in its discretionary power, it is inevitable that the ultimate offer price will not be the highest possible. Indeed, it is submitted that investment banks may be more biased towards institutional investors, resulting in a greater tendency to underprice. This is in light of the long-term relationships between underwriters and many institutional investors. These investors often return to purchase shares from the same underwriter, in whom they have established trust. On the other hand, issuers are likely to have only temporary relationships with investment banks, as it is not likely that they will list the company's shares more than once.[40] Even where there is no existing long-term business relationship, an increase in payouts to hedge funds and other large investors can help underwriters develop yet another group of loyal investors for future issues.[41]

In addition, misalignment of incentives can also arise due to conflicting interests between the issuing firm's profit maximisation goal and the underwriter's immediate concerns (interest-duty conflicts of interest). In particular, the problem of interest-duty conflicts will be trickier than duty-duty conflicts, given that the underwriter's fundamental interests will be directly affected. For instance, the issuer's desire to maximise capital raising is at odds with the underwriter's primary concern to minimise selling efforts for the offering. When contracting with issuers, underwriters use either a firm commitment underwriting, or best efforts underwriting. In a best efforts underwriting, an underwriter agrees to a fee for its best

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[37] Francesca Cornelli and David Goldreich, 'Bookbuilding and Strategic Allocation' (2001) 56(6) The Journal of Finance 2337, 2337.

[38] Ross Cranston, 'Conflicts of interest in the multifunctional financial institution' (1990) 16(1) Brooklyn Journal of International Law 125.

[39] FCA Handbook, Senior Management Arrangements, Systems and Controls 10.1.14G.

[40] Timothy G Pollock, 'The benefits and costs of underwriters' social capital in the US initial public offerings market' (2004) 2(4) Strategic Organization 357, 358.

[41] Timothy G Pollock, Joseph F Porac and James B Wade, 'Constructing deal networks: Brokers as network 'architects' in the U.S. IPO market and other examples' (2004) 29 Academy of Management Review 50, 58.

efforts to sell the issue, with the issuer bearing risks of the shares not selling quickly, or not selling at all. In a firm commitment underwriting, the underwriter agrees to purchase a fixed number of shares from the issuer at a discount before selling them to investors.[42] As the latter is more commonly used in the UK, it will be further discussed here.

By purchasing the whole offering in a firm commitment underwriting, underwriters assume the risk of an unsuccessful offering. An issue that does not sell gives rise to both direct and indirect costs. Crucially, any unsold shares, or shares that do not sell quickly may adversely affect future businesses. If the shares are not fully sold, the underwriting firm may suffer from reputational harm among issuers, resulting in the loss of future issues to underwrite.[43] Investors may also be less willing to purchase future shares that are underwritten by the firm, since unsold shares may reflect poor judgments by underwriters on the offering.[44] Since one of the main advantages of bookbuilding is also the fact that issuers are able to capitalise on the existing relationships between the underwriter and its regular investors, ensuring a minimum demand for the offering, it is likely that underwriters will receive fewer desirable offerings as the underwriter-investor relationships worsen, thereby triggering a vicious cycle. Therefore, to ensure a minimum level of demand, underwriters may underprice to create a large spread between the offering price and the anticipated aftermarket price, since investors will be enticed to purchase shares that will certainly have a price rise. Admittedly, this may not always be the case. After all, since raising offer prices maximises underwriting fees, underwriters also have clear financial incentives to obtain high offer prices. As such, it is when the risks of an unsuccessful offering outweigh the additional gains from increasing offer prices that underwriters will resort to substantial underpricing that is contrary to the issuer's goal to maximise profits. In other words, any benefits obtained by issuers in bookbuilding appear to be more coincidental than conscious attempts by the underwriter to pursue the issuing firm's interests.

The second potential area of conflict is allocation. Given numerous profit-seeking considerations (for instance, extra commissions), it is also probable that underwriters will use their discretionary powers for their own benefits. As a result, shares allocation may not be aligned with the issuing firm's desired pool of investors. Indeed, FCA's research findings suggest that allocation decisions may reflect the interest of the banks,[45] and '[underwriters]

[42] FCA Handbook, Perimeter Guidance Manual 13.3.
[43] Loughran and Ritter, 'Why has IPO underpricing changed over time?' (n 36).
[44] ibid.
[45] FCA, 'Market Study Investment and corporate banking market study Interim report' (MS15/1.2, FCA 2016) para 1.32.

often favour their prime brokerage and hedge fund clients when allocating the shares in an IPO, which may not be in the interests of the issuer'.[46] In addition, separate research on European investment firms also found that the broking relationship with the underwriter is perceived to be the most influential factor in determining share allocations.[47] Empirical evidence also suggests that underwriters are often incentivised to allocate shares based on commissions received, and not necessarily according to the issuer's best interests.[48]

The lack of transparency of the underwriter's discretion in relation to shares allocation may also further aggravate underpricing. A case in point is the relation between allocation and commissions received. Institutional investors often engage in rent-seeking behaviour to compete for allocations of underpriced shares, and one way to do so is to offer underwriters excessive commission rates.[49] Although underwriters have financial incentives to obtain high prices (as mentioned), conflicts arise when compensations obtained for money left on the table (ie the first-day price gain multiplied by the number of shares sold)[50] outweigh direct underwriting fees received from issuing firms. This is possible since issuers generally appear to view opportunity costs in the form of money left on the table as less than the direct costs underwriting fees. For example, while $18.87 million were left on the table, only $3.66 million direct fees were paid in the 1986 Microsoft IPO.[51] Similarly, the amount left on the table in the 2011 LinkedIn IPO was approximately ten times the underwriting fees paid.[52] Arguably, this may be due to the fact that neither of these costs is reflected in the issuing firm's income statements, hence resulting in misjudgements of costs.[53] In fact, a study conducted by Ljungqvist shows that a one percent increase in direct underwriting fees reduces underpricing by 11 percent in the UK.

Other examples include laddering and spinning. Laddering refers to the practice of allocating underpriced shares to institutional investors who agree to purchase additional shares in the aftermarket at a higher price.[54] The effect of laddering is an artificial increase in demand,

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[46] FCA, 'Wholesale sector competition review 2014-15' (FCA 2015) 17.
[47] Jenkinson and Jones (n 19) 1495.
[48] Michael A Goldstein, Paul Irvine and Andy Puckett, 'Purchasing IPOs with Commissions' (2011) 46(5) Journal of Financial and Quantitative Analysis 1193.
[49] FCA 'Market Study Investment and corporate banking market study Interim report' (n 45); Jonathan Reuter, 'Are IPO Allocations for Sale? Evidence from Mutual Funds' (2006) 61 (5) The Journal of Finance 2289, 2322; Mahendrarajah Nimalendran., Jay R Ritter and Donghang Zhang, 'Do today's trades affect tomorrow's IPO allocations?' (2007) 84 Journal of Financial Economics 87, 108.
[50] Loughran and Ritter (n 35) 413.
[51] Bro Uttal, 'Inside the Deal that Made Bill Gates $350,000,000' *Fortune* (New York, 21 July 1986) 32-33.
[52] Joe Nocera, 'Was LinkedIn Scammed?' *The New York Times* (New York, 21 May 2011) A19.
[53] Loughran and Ritter, 'Why don't issuers get upset about leaving money on the table in IPOs?' (n 35) 425.
[54] Qing Hao, 'Laddering in Initial Public Offerings' (2007) 85 Journal of Financial Economics 102, 103.

which leads to the rise of aftermarket share prices. When underwriters profit from these investors' extra earnings through high commissions, laddering provides additional value to underwriters and underpricing increases. Spinning refers to the market practice of shares being sold by specific individual investors immediately in the aftermarket for a quick profit. More specifically, shares may be allocated to corporate managers of both public and/or private companies for a quick 'spin' and these individuals benefit at the expense of pre-existing shareholders, whose shares are diluted as a result of underpricing, on top of an increased number of shares. Therein also lie problems between the principals and agents within the issuing firm, but which is beyond the scope of this paper.

Although conflicts of interest may be mitigated with efficient and effective monitoring efforts, this can be difficult to achieve in a bookbuilding regime as a result of information asymmetries and financial sophistication. As the main administrators of the bookbuilding process, underwriters have complete control of the information gathered during the process. This gives them a significant informational advantage over the issuer, thus undermining the issuer's ability to monitor the underwriter. [55] In particular, the greater the ex ante uncertainty of the firm's value, the greater the informational asymmetry between the issuer and the underwriter. Since the underwriter has more price-relevant information than the issuer, it is likely to create imbalance during pricing negotiations with the issuing firm. [56] This is exacerbated by the fact that the pricing data are often presented in a complex and sophisticated form that the issuer is incapable of understanding.[57] Similarly, given that the allocation criteria are not expressly set out, monitoring efforts in relation to whether the interests of the issuer are considered for shares allocation can be difficult and time consuming.[58]

2. *The legal framework*

In light of the undesirable consequences of conflicts of interest, the following parts of this Section analyse if the issue of conflicts of interest has been adequately controlled under the current legal regime.

[55] David P Baron and Bengt Holmstrom, 'The Investment Banking Contract for New Issues Under Asymmetric Information: Delegation and the Incentive Problem' (1980) 35 The Journal of Finance 1115, 1119.
[56] David P Baron, 'A Model of the Demand for Investment Banking Advising and Distribution Services for New Issues' (1982) 37 The Journal of Finance 955, 975-976.
[57] Sean J Griffith, 'Spinning and Underpricing: A Legal and Economic Analysis of the Preferential Allocation of Shares in Initial Public Offerings' (2004) 69 Brooklyn Law Review 583, 619.
[58] FCA, 'Wholesale sector competition review 2014-15' (n 46) 20.

a) Common law

The English common law position on the issue of whether the relationship between underwriters and issuing firms during an IPO price formation process is fiduciary in nature has yet to be established. This is arguably attributed to the FCA's extensive rule-making powers, which have resulted in the substantive law being largely contained in regulatory rules, rather than in statutes, and hence 'stunt[ed] the growth of common law'.[59] The underwriter-issuer relationship does not fall within the well-recognised categories of fiduciary duty under English law (ie trustees, directors, agents, business partners).[60] Thus far, there is also no case law that directly addresses the character of the underwriter-issuer relationship. The only case that comes close to the issue is *United Pan-Europe v Deutsche Bank*,[61] in which Deutsche Bank was found to owe fiduciary obligations to a firm to which it had loaned funds. However, the argument on fiduciary obligations was not made on the basis that Deutsche Bank took on the role of an underwriter in the firm's IPO a year before. The judicial position on the underwriter-issuer relationship therefore remains unanswered.

In theory, an underwriter acting in the capacity of a financial advisor in the context of the IPO price formation process is capable of being a fiduciary. A fiduciary refers to 'someone who has undertaken to act for or on behalf of another […] in circumstances which give rise to a relationship of trust and confidence'.[62] It therefore follows that fiduciary obligations may be imposed in commercial circumstances where a party relies upon financial advice provided by an investment bank, which is acting in its capacity as a financial/corporate advisor.[63] Such circumstances would clearly include situations when the underwriter undertakes the role of a financial advisor during the price formation process to advise on issues such as the design, pricing, and timing of the offering. Countervailing arguments that the underwriter cannot be deemed to be in a position of power and influence over the issuing firm, given the latter's financial sophistication, are unpersuasive. As discussed in subsection 1 above, issuing firms often lack the relevant expertise and knowledge as to market demand and financial data in relation to pricing the IPO. The underwriter-issuer relationship can therefore fall within the definition of fiduciary obligations.

[59] Julia Black, 'Law and Regulation: The Case of Finance' in Christine Parker and others (eds), *Regulating Law* (OUP 2004) 45-49.
[60] Alastair Hudson, *The Law of Finance* (2nd edn, Sweet & Maxwell 2013) 98.
[61] *United Pan-Europe v Deutsche Bank* [2000] 2 BCLC 461.
[62] *Bristol and West Building Society v Mothew* [1998] Ch 1 (CA) 18 (Millett LJ).
[63] *Daly v Sydney Stock Exchange Ltd* (1986) 160 CLR 371; *Wood v Martins Bank* [1959] QB 55; *Standard Investments Ltd v Canadian Imperial Bank of Commerce* (1985) 2 DLR (4th) 410.

Nonetheless, the English courts have been reluctant to impose fiduciary obligations on a commercial relationship, as the parties to a transaction are deemed to have had sufficient opportunities to prescribe obligations and remedies through negotiations and, more importantly, so as to ensure commercial certainty.[64] This is especially since fiduciary duties can be modified or excluded under contractual law, subject to the 'good faith' test under Regulation 4(1) of the Unfair Terms in Consumer Contracts Regulations 1999.[65] Furthermore, both the issuing firm and the underwriters in an IPO are sophisticated parties. Thus, it appears unlikely that the English courts will follow the New York case of *EBC I Inc v Goldman Sachs & Co*, where it was held that although fiduciary duties do not typically exist in the underwriter-issuer relationship, advising the issuer on pricing the IPO can be sufficient to impose a fiduciary duty.[66] It will likely be an uphill struggle for a party to claim before the English courts that a fiduciary relationship has arisen in such circumstances.

Indeed, it could be argued that the courts should take a more lenient approach when determining fiduciary obligations of underwriters within the circumstances of an IPO price formation process.[67] Instead of relying solely on FCA regulations (as will be discussed below), the common law provides an additional form of enforcement by issuing firms and other market participants, and hence encourages greater monitoring by market participants. This might provide greater deterrence to inappropriate pricing and allocations, thus achieving greater fairness, efficiency, and transparency. However, due to the fact that the courts will interpret the common law in accordance with the regulatory rules when there is an inconsistency between the two, it will be of limited practical significance even if fiduciary obligations are enforced. This is especially so with regard to conflicts of interest, where there are several inconsistencies between common law and the FCA regulatory rules. Whilst common law requires fiduciaries to *avoid* any conflicts of interest, Principle 8 of the FCA Principles for Business (PRIN) and chapter 10 of the FCA's Senior Management Arrangements, Systems and Controls Sourcebook (SYSC) only expect investment firms to *manage* such conflicts of interest. Under section 2.3 of the FCA Conduct of Business sourcebook (COBS), exceptions to the 'no inducement' rule are narrow, whereas under the common law, the fiduciary may receive a wide range of benefits if its client specifically agrees to it. In such circumstances, the English courts will 'attach

[64] *JP Morgan Chase v Springwell Navigation Corporation* [2010] EWCA Civ 1121; *Vercoe v Rutland Fund Management* [2010] EWHC 424 (Ch) at [352].
[65] Note that the exclusion of fiduciary liabilities does not fall within the scope of the Unfair Contract Terms Act 1977, as the Act applies only to liability for breaches of contract or negligence.
[66] *EBC I Inc v Goldman Sachs & Co*, 2005 NY Lexis 1178.
[67] See Jay Ze, 'Underwriters and fiduciary duties' (2007) Journal of Business Law 137.

considerable weight' to regulations,[68] and underwriters are unlikely to be liable under fiduciary law if they abide by the FCA regulatory rules. This also means that, in any case, any fiduciary duty that may be owed by an underwriter will not differ substantially from what is stipulated in the FCA regulations. This renders any debate on whether fiduciary obligations should be imposed on underwriters to be of little significance.[69] Accordingly, as the English courts are generally reluctant to interfere with a commercial relationship, and as the common law duties will be interpreted in accordance to contractual law and regulatory rules, it is submitted that the FCA regulations are particularly crucial for regulating the issue of conflicts of interest between the underwriter and the issuer in the price formation process.

b) The regulatory framework

The Financial Services and Markets Act 2000 (FSMA) confers wide-ranging rule-making powers on the FCA.[70] The main regulations that are relevant for our purposes are the Rules and Guidance provided in PRIN, COBS and chapter 10 of the SYSC. The primary advantage of the FCA regulations is that, unlike the exclusion clauses that are allowed under common law, and subject to exceptions, COBS 2.1.2R forbids a firm to exclude or restrict any duty or liability it has to a client under the FCA regulations. The guidance in COBS 2.1.3G qualifies COBS 2.1.1R by providing that exclusions or restrictions may be allowed if they are 'honest, fair and professional for [the firm] to do so', emphasising COBS 2.1.1R to act 'honestly, fairly and professionally' in its client's best interests. This helps to ensure that fairness is maintained in the markets.

In relation to IPO allocations, the Financial Services Authority (FSA) (the predecessor of the FCA) established that the acceptance of extra commissions and the market practices of laddering and spinning would be in breach of COBS 2.3.1R, which prohibits the offer/acceptance of commissions that are likely to conflict with the duty owed to customers.[71] Yet it is unclear if these provisions sufficiently deter improper trading activities to ensure fairness in the IPO markets. Although the FSA found no clear evidence of exploitations in their own research findings, they identified 'anomalies in share price movements' and there were also 'suspicions of unsatisfactory practices'.[72] In addition, the fact that firms retain minimal

[68] *Gorham v British Telecommunications plc* [2000] 1 WLR 2129, 2141.

[69] See Andrew F Tuch, 'Securities Underwriters in Public Capital Markets: The Existence, Parameters and Consequences of the Fiduciary Obligation to Avoid Conflicts (2007) 7(1) Journal of Corporate Law Studies 51; cf Ze (n 67).

[70] Financial Markets and Services Act 2000, s137A.

[71] Financial Services Authority, 'Conflicts of Interest: Investment Research and Issues of Securities (CP 171)' (FSA 2003) 31.

[72] ibid 31.

records on their IPO allocations is one reason to be cautious about the FSA's modest assessment of the real level of abuse.[73]

More generally, investment banks have an overarching obligation to 'manage conflicts of interest fairly, both between itself and its customers and between a customer and another client'.[74] Chapter 10 of the SYSC sets out specific requirements to disclose and manage conflicts of interest. In particular, SYSC 10.1.15G states that the underwriter:

> might wish to consider […] agreeing […] with [the issuer …] what recommendations [the underwriter] will make about the allocations for the offering; how the target investor group will be identified; how recommendations on allocation and pricing will be prepared; and whether the firm might place securities with its investment clients […] and allocation and pricing objectives.[75]

It is noteworthy that SYSC 10.1.15G is the only provision in the FCA Handbooks that directly addresses the issue of pricing and allocation in an IPO. Discussing pricing and allocation strategies openly with the issuing firms improves transparency through timely supply of the relevant information, thus keeping in check potential abuses of conflicts of interests. Furthermore, an open communication process helps issuers to assess pricing and allocation recommendations, especially when allocation is made to the bank or its affiliate, and therefore ensures that the outcome of an IPO will be to their best interests. From the market's perspective, it is also more likely that information will be reflected in the final initial price, and hence SYSC 10.1.15G potentially aids in achieving the market objectives of fairness, efficiency and transparency. Nevertheless, the wording of SYSC 10.1.15G ('*might* wish to consider') indicates that the rule does not impose a strict obligation on the underwriter. This is affirmed by the status of the provision as 'Guidance' under the FCA Sourcebook. In other words, the provision is not binding, and underwriters will not incur disciplinary liability just because they did not follow the provision.[76] As such, it is doubtful whether the SYSC requirement actually goes beyond providing mere guidance to have any practical implications towards achieving market objectives, especially in relation to 'individuals who have no principles'.[77]

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[73] ibid.

[74] FCA Handbook, Principles of Business 2.1.

[75] FCA Handbook, Senior Management Arrangements, Systems and Controls Sourcebook 10.1.15G.

[76] FCA, 'Reader's Guide: an introduction to the Handbook' (FCA 2013) 24.

[77] Hector Sants, 'Delivering Intensive Supervision and Credible Deterrence' (Speech delivered at the Reuters Newsmaker Event, 12 March 2009) <http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2009/0312_hs.shtml> accessed 5 August 2015.

In addition to this, the FCA provisions that apply to the IPO pricing process and underwriters in general are limited, as laid out in COBS 18.3.1. The FCA also suggests that some rules are unlikely to apply in such circumstances, the most notable being the best execution rule under COBS 11.2.1R, which is central to the European Union Markets in Financial Instruments Directive I (MiFID I).[78] Circumstances that give rise to proscribed conflicts of interest are also relatively limited. According to SYSC 10.1.5G, conflicts of interest do not occur when loss has not been caused to the client, or a client has not earned at the expense of another client. However, as explained at the start of this Section, the presence of conflicts of interest is itself detrimental to achieving all market objectives of fairness, efficiency, and transparency. It is therefore submitted that the existence of a conflict of interest and the action of the underwriter should be allowed to qualify as proscribed conflicts of interest under the SYSC.

An overall assessment of the FCA regulations further demonstrates that the current UK regulatory framework is unsatisfactory in advancing market aims. Firstly, the effectiveness of the FCA's enforcement remains to be seen. Although it has been ten years since the regulations on conflicts of interest were reviewed,[79] there has yet to be any sanction on underwriters with regards their failure to manage conflicts of interest during the IPO process. Indeed, a lack of formal enforcement action does not necessarily imply or lead to a lower level of compliance, particularly since formal enforcement actions are only one of the regulatory tools that the FCA relies on to deal with contravention.[80] However, there is also no evidence to suggest that a high level of compliance has been achieved. Apart from the aforementioned suspected activities in relation to laddering and spinning, research by the FCA in 2014 continues to suggest that biased allocations potentially occur in practice.[81] The London Stock Exchange's survey findings in 2011 also found that '95 percent of investors do not trust banks when they are pricing and allocating IPOs, or want more transparency from them'.[82] Hence, it is questionable if much compliance has been attained. The lack of enforcement in this area therefore indicates that the regulation has been more bark than bite. Indeed, the unsatisfactory level of enforcement does not seem to be confined to the sphere of underwriting in the pricing process. A recent sanction

[78] FCA, 'Best execution and payment for order flow' (TR 14/13, FCA 2014).
[79] FSA, 'Conflicts of Interest: Investment Research and Issues of Securities (CP 171)' (n 71); FSA, 'Conflicts of Interest: Investment Research and Issues of Securities (CP 205)' (FSA 2003).
[80] FCA Handbook, Enforcement Guide para 3.2.
[81] FCA 'Wholesale sector competition review 2014-15' (n 46).
[82] London Stock Exchange Group, 'Leadership in a Changing Global Economy: The Future of London's IPO Market' (LSE 2011) 13.

on an asset management firm for breach of PRIN 8 by the FCA came only after eight years of the firm's failure to manage conflicts of interest fairly.[83]

Secondly, even if underwriters were to be sanctioned for the failure to manage conflicts of interest, issuers are unlikely to be able to claim against loss under the FCA regulatory rules. This is because only some regulations are actionable under section 138D of FSMA. For instance, both SYSC 10 and PRIN, which are the main provisions for managing conflicts of interest, are not actionable. Breaching a Principle only makes a firm liable to FCA disciplinary sanctions and it does not give rise to any private claims for loss.[84] This means that issuers cannot be compensated for any loss that results from exploitations of conflicts of interest. In this regard, PRIN 8 does not sufficiently protect the issuers' interests. In addition, although 'a private person' may, pursuant to section 138D of FSMA, sue an investment bank who has caused them a loss through a breach of the FCA rules, this right is extremely limited. To obtain standing for the claim, the claimant must be 'a private person' (as defined in the Right of Action Regulations)[85] and corporate persons may only rely on the provision if they are not 'conducting business of any kind'.[86] In *Titan Steel Wheels Ltd v Royal Bank of Scotland plc*, a steel manufacturer who was sold inappropriate swaps by a bank was held to be conducting business even though it was not experienced in financial markets, and was therefore unable to rely on section 138D of FSMA.[87] As such, it could be difficult for an issuing firm to rely on section 138D of FSMA for a claim for loss. Furthermore, section 151 of FSMA provides that no contravention of an FCA rule makes any transaction void or unenforceable. Hence, it is submitted that the present regulatory framework does not provide sufficient sanctions and remedies to deter and correct cases where the market objectives of fairness, efficiency, and transparency have been foiled.

The inadequacy of the current regime is further illustrated by the fact that the same issue remains one of concern years after the review of the regulations in relation to conflicts of interest in 2003, as well as the incorporation of MiFID I in 2007. This is evinced in the FCA's 2015 Market Study to address transparency issues during the allocation process,[88] a 2014

[83] FCA, 'Final Notice 2015: Aviva Investors Global Services Limited' (FCA 2015).
[84] FCA Handbook, 'Principles of Business' (n 74) 1.1.7G.
[85] Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001, SI 2001 No 2256, reg 3.
[86] ibid reg 3(1)(b).
[87] *Titan Steel Wheels Ltd v Royal Bank of Scotland plc* [2010] EWHC 211.
[88] FCA ,'Investment and corporate banking market study: Terms of reference' (n 5).

independent review on IPO and Bookbuilding, [89] as well as enhanced transparency requirements in the amended MiFiD I (MiFID II), due to take effect in the UK in 2017.[90]

3. Auctions

On the other hand, auctions set down all allocation criteria explicitly and allocations take place under an automated system. These pre-defined allocation principles leave underwriters with little discretion on the allocation of shares and leads to a greater likelihood that the final allocation and pricing will be in the issuer's interests. The increased transparency may therefore render auctions more desirable to bookbuildings, whereby allocations are decided behind the door. However, such transparency also comes at the expense of discretion in allocations and pricing, as aforementioned, which greatly impedes an efficient price formation process. In addition, an auction system is also risky because of unpredictable future demand. Wide variations in the number of bidders per auction are common. In Singapore for example, the number of bidder can vary from 1,128 to 162,492 in different auctions. [91] As a result, there is an increased possibility of the offering being undersubscribed. Indeed, in the 2004 Google IPO, the issuer was forced to lower the price range due to a lack of demand at the original price range.[92] On the other hand, there is more control over future demands in bookbuildings, as investors who are invited to take part in the bookbuilding process will most likely take up the offering.

Crucially, the auction system has not worked well in practice. This can be illustrated by the 2004 Google IPO. According to the Myners Report, allocation criteria can be built into the auction system to mitigate the aforementioned problems.[93] This is indeed what Google sought to achieve, by including the right to reserve the right to price below market-clearing, the right to throw out excessively high bids that it considered speculative, and limiting the maximum possible number of bidders, which essentially eliminates free-riders from bidding. However, despite Google having controlled certain aspects of the IPO, the value and size outcomes were still substantially below expectations and did not meet Google's original objectives. The level of underpricing was also relatively high, at 18 percent.[94]

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[89] Myners (n 2).
[90] Directive 2014/65/EU on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU (recast) [2014] OJ L173/394.
[91] Ravi Jagannathan, Andrei Jirnyi and Ann E Sherman, 'Share auctions of initial public offerings: Global evidence' (2015) 27 Journal of Financial Intermediation 283, 295.
[92] Ramirez (n 6) 87.
[93] Myners (n 2) 58.
[94] Ramirez (n 6) 87.

Thus, whilst the UK bookbuilding mechanism suffers from the problem of a lack of transparency in respect of the underwriter's discretionary powers, giving rise to potential abuses, this does not necessarily indicate that the bookbuilding mechanism should be radically replaced with an auction system. Although the enhanced transparency of an auction system removes the problem of conflicts of interest in its entirety, it introduces other problems such as uncertainty and an inefficient price discovery process. Ultimately, given that a further analysis on the present UK legal regime reveals that the issue of transparency remains a concern, it is suggested that the present UK bookbuilding system should be retained but with the regulatory improvements proposed in Section D below. These improvements are required as, while the significance of the common law has been greatly reduced due to the FCA's extensive regulatory powers, the FCA regulations remain limited in addressing issues pertaining to conflicts of interest. This is as a result of the discretionary nature of the regulations, its narrow scope, and the lack of both public and private enforcement.

D. REGULATORY DEVELOPMENTS

1. Disclosure of allocation criteria

This paper contends that an optimal pricing mechanism is one that combines both the merits of the bookbuilding and auction structure. Specifically, it should enhance the transparency of the pricing and allocation process and, at the same time, retain a certain degree of discretion on the underwriter's part in order to facilitate price discovery. Above all, an optimal IPO mechanism is one that exhibits 'fairness, efficiency and transparency'.[95] Consequently, the first part of this Section rejects Australian Bookbuilding (ASX Bookbuilding) that has been 'strongly encouraged' in the Myners Report,[96] before proceeding to propose an alternative system that better balances the concurrent needs for discretion and transparency.

a) ASX Bookbuilding

ASX Bookbuilding was introduced by the Australian Stock Exchange (ASX) in 2013. ASX Bookbuilding aims to, inter alia, improve transparency and efficiency of the IPO process, while enabling issuers and lead managers to retain sufficient control over pricing and allocation decisions.[97] Under ASX Bookbuilding, the issuer and its lead manager first decide on the preliminary deal parameters, including the total allocation amount and identifying preferred

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[95] Myners (n 2) 57.
[96] Myners (n 2) 58.
[97] On-Market Bookbuilds (OMB), 'ASX Bookbuild' (OMB 2015) <http://www.onmarketbookbuilds.com/70/ASX-BookBuild> accessed 7 August 2015.

investors to invite 'priority bids' from those investors. After collecting the priority bids, ASX Bookbuilding opens. All eligible investors may bid and a live bid price (but not market depth or volume) is visible to all bidders.

This enhances the transparency of pricing outcomes, which reduces conflicts of interest. At the same time, the issuer and the lead manager are able to see the number and depth of bids and can adjust the parameters, such as the proportion of priority bidders as versus on-market bidders, according to their desired commercial outcomes. Some discretionary powers are thereby retained. It is also worth noting that ASX Bookbuilding has been openly endorsed by the Myners Report as an option to improve the transparency of the UK price formation process, although it was only mentioned in passing.[98]

A closer look at the innovative ASX mechanism however reveals several flaws. ASX Bookbuilding establishes a fixed set of rules for shares allocations that are to be applied in every IPO. Priority bidders with bids placed at or above the final bookbuild price receive a priority allocation. This is followed by the price leader allocation phase, which rewards price leaders for contributing to the price discovery. The remaining shares are allocated to bids that are priced above the final offer price on a pro-rata basis.

Prima facie, the price leader allocation phase may facilitate price discovery. However, it is doubtful if such allocation would in fact aid in ensuring an optimal initial price. The mechanism does not enable issuers to differentiate between informed and uninformed on-market-bids. Whilst some bidders may have conducted detailed professional valuation and analysis on the issuing firm, others may be free-riders (as detailed above in Section B.3). In other words, the demand curve obtained through ASX Bookbuilding may only appear accurate on the surface, as compared to the bookbuilding regime.

As much as ASX Bookbuilding provides some discretion in identifying 'priority bidders', the issuer does not have any discretion to reduce allocation to any specific bidders. The presence of these standard allocation rules limits the issuer's capacity to deter bids that may harm the company. Furthermore, the standard allocation principles focus only on whether the bids are placed at or above the final bookbuilding price and the qualities of the bids (for example, whether the investor will be a long-term holder) are beyond consideration.[99] Although this may suggest that the allocation process is fair, it also means that the issuer will be oblivious to any short-sellers and bidders who do not have the tendency to maintain

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[98] Myners (n 2) 58.

[99] On-Market Bookbuilds (OMB), 'ASX Bookbuild' (OMB 2015) <http://www.onmarketbookbuilds.com/70/ASX-BookBuild> accessed 7 August 2015.

allocations. The identities of the on-market bidders are also anonymous to the issuer and the system does not allow the issuer to have regard to a bidder's history of market behaviour in making allocations.[100] It could be maintained that ASX Bookbuilding provides sufficient control over preferential investors by allowing issuers to select priority bidders. However, it is as important to enable issuers to remove bidders of low quality where they deem fit, particularly given the strong emphasis that listed companies place on ensuring the quality of share registers.[101]

ASX Bookbuilding, unlike what its title suggests, is in fact premised on an auction system. This foundation however, as seen in the previous sections, is fundamentally deficient. Coupled with the fact that ASX Bookbuilding limits discretion and price discovery, a better model should be one that is based on the bookbuilding mechanism, which is better able to provide a good equilibrium between both discretion and transparency.

b) Proposed disclosure requirements

The proposed system retains the current bookbuilding model as its core, while incorporating new disclosure requirements (hereby referred as modified bookbuilding). Through the underwriters' discretion in allocation in the traditional bookbuilding system, issuing firms will not only be able to consider the prices of bids, but also ensure their qualities. After all, an IPO is a complex process, which requires companies to achieve a balance between many competing factors. Accordingly, a well-functioning IPO mechanism should also offer flexibility and discretion for companies to attain both their IPO objectives and commercial goals in the long-run.

Nonetheless, the traditional bookbuilding system has to be modified for greater transparency. More specifically, while ensuring discretion in allocations, mandatory disclosure regarding allocation criteria should be enforced. Currently, the sole regulation that comes close to this is SYSC 10.1.15G, which only provides for an optional regime to conduct a discussion between the issuer and underwriters with regard pricing and allocation criteria. However, these allocation criteria should in fact be expressly agreed upon and set out at the early stage of the IPO process, rather than being deployed in private meetings. Such criteria may include the amount of positive information provided for pricing the issue, the probability of the investor being a long-term holder and the investor's willingness to place early bids.[102] In particular,

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[100] Australian Securities Exchange (ASX), 'ASX Bookbuilding: Bringing efficiency, fairness and transparency to the primary equity market' (Consultation Paper, ASX 2012).
[101] Letter from Stockbrokers Association of Australia (SAA) to Australian Stock Exchange (26 October 2012).
[102] Ravi Jagannathan and Ann E Sherman, 'Reforming the Bookbuilding Process for IPOs' (2005) 17(1) Journal of Applied Corporate Finance 67, 69.

these allocation principles should be 'well-understood criteria that can be inferred with reasonable confidence from investors' past behaviour'.[103] Any principle that is applied but not commonly used in the market must be clearly justified.

Since the assessment of various yardsticks remains highly subjective, it is also suggested that the issuer and its underwriter are required to rank the different allocation criteria according to the issuer's preference. For instance, stability may be most crucial in light of the issuer's circumstances and, in such a case, the need for long-term holders will be more important than whether the investor is willing to place early bids. Indeed, it may be arbitrary to categorise the different criteria so distinctly and investors should be judged as a whole to determine suitability. Thus, an appropriate compromise would be to establish different tiers of criteria according to their levels of importance and each tier may consist of a few allocation principles.

Admittedly, the modified bookbuilding structure may limit the underwriter's discretion to a small extent. However, this does not impede price discovery. Based on the allocation criteria, bids providing information that helps in facilitating price discovery may be prioritised over other bids. For example, limit bids could be favoured over strike bids, considering that the latter only provide information on quantity but not price. To better ensure that efficient price discovery takes place, the criterion regarding the amount of information revealed could be made mandatory and it should rank as one of the most important factors to be taken into consideration.

On one hand, the modified bookbuilding model provides wider transparency, as compared to the current bookbuilding regime. By making allocation criteria clear and explicit, investors would be able to know in advance how their choices would affect the priority assigned to their order. Additionally, there is less scope for underwriters to exploit their discretionary power since they would have to account for any discrepancies. Any signs of such exploitation should also trigger the relevant regulations on conflicts of interest,[104] which also aids in increasing public enforcement levels. Consequently, modified bookbuilding limits abuses by keeping in check the use of the underwriter's discretionary powers. Given that excessive underpricing can be largely attributed to exploitations of conflicts of interest, modified bookbuilding also indirectly reduces the level of underpricing. Any underpricing that otherwise occurs is due to the need for compensations for information revelation.

[103] ibid.
[104] See Section C.2.b.

On the other hand, in contrast to the standard allocation rules in ASX Bookbuilding, modified bookbuilding also allows allocation principles to be more personalised and suited to specific IPOs. It enables the issuing firm and its underwriter to take into account a variety of factors during the allocation process, rather than a single factor of the price of bids. It therefore addresses concerns that are beyond the proceeds of the IPO, such as an investor base with loyal long-term holders, as well as limiting the risks of failure.

While firms may be concerned that it would be difficult to disclose precise allocation criteria at the early stages of the IPO, this should not be an issue as the aforementioned disclosure remains at a fairly broad level. Such a view has also been supported by the FCA, which expressed that 'it should be possible to discuss allocation strategy in a broad sense'. Accordingly, the proposed disclosure regime is highly practical. Moreover, there have also been precedents for such modified bookbuilding in the past in the UK. In 1995, the seasoned equity offerings of National Power and PowerGen also sought to enhance the transparency of its bookbuilding to investors in a similar manner. Specifically, investors were divided into six categories of investor quality, based on criteria such as the price offered, and firm bids, as well as the likelihood of buying or holding shares in the aftermarket.[105] The proposal to disclose allocation criteria would thus not be an entirely foreign concept.

2. Private enforcement actions

The overall effectiveness of the proposed disclosure framework has to be backed by an effective enforcement regime. Presently, the level of enforcement in the UK, which is almost entirely dependent on regulatory authorities, has been extremely low.[106] It is thus submitted that section 138D of FSMA should also be extended to private actions, alongside the mandatory disclosure of allocation criteria at the outset that may aid in the regulators' detections of failures to manage conflicts of interest. In this regard, the Law Commission has argued that an extension of section 138D of FSMA might increase litigation risks and costs, and promote overly defensive behaviours.[107] However, these arguments, which were based on consultation responses, are unconvincing. Firstly, it was acknowledged in the report that the effects of the change are 'uncertain',[108] that is, the problems associated with an extension of section 138D of FSMA are merely speculative. Secondly, the consultees who were quoted to be against the

[105] David Parker, *'The official history of privatization Volume II: Popular Capitalism, 1987-1997'* (Routledge 2012) 395.
[106] See Section C.2.
[107] Law Commission, *Fiduciary Duties of Investment Intermediaries* (Law Com No 350, 2014) para 11.33.
[108] ibid.

extension consisted mainly of investment intermediaries,[109] thus casting doubt on the impartiality of their responses.

On the other hand, extending section 138D of FSMA to private claims allows issuers to exercise market discipline and enhances monitoring of underwriters, and hence better control abuses of conflicts of interest. Such extension is especially favourable considering the current lack of regulatory enforcement, and the limited applicability of the common law regime, as detailed in Section C.2. Fears of excessive increased litigation risks are unfounded, given the UK's relatively less active private securities litigation culture compared to the US.[110] Moreover, underwriters should have nothing to fear if they can demonstrate that the decision was taken after due process and consideration.

E. CONCLUSION

The equity-raising market is paramount on several levels. It is critical to the well-being of firms and it also affects the efficiency of secondary trading markets. At the same time, a fair, efficient and transparent IPO market is an integral component of an allocative efficient economy. As the price formation process plays a central role in IPOs, this paper has sought to review the current UK pricing mechanism. In particular, it is argued that while the UK bookbuilding mechanism has its flaws, it is not without significant merits. These include its strength in facilitating information revelation, as well as other advantages associated with discretionary shares allocation. Furthermore, it is not the underwriter's discretionary power on shares allocation and pricing per se that leads to conflicts of interest; rather, it is the lack of transparency associated with the discretion that is problematic. In other words, the inherent features of the UK bookbuilding system are beneficial.

While critics have proposed the replacement of the bookbuilding system with the auction system, the latter is itself plagued with its own share of problems. Thus, there is no real need to replace the pricing model with the auction system, particularly since the latter introduces additional issues. Recognising the deficiencies of a pure auction model, some have also suggested the approach adopted in Australia. Although ASX Bookbuilding appears to be appealing, it is not without difficulties. Specifically, it removes the advantages of discretion that are associated with the present UK bookbuilding system. Its fundamental base of an auction system is also undesirable. On the other hand, the modified bookbuilding system

[109] ibid paras 11.28-11.31.

[110] Iris HY Chiu, 'Initial Public Offers – The Supply and Demand Side Perspectives in the Legal Framework' in Dan Prentice and Arad Reisberg (eds), *Corporate Finance Law in the UK and EU* (OUP 2011) 165-166

proposed in this paper retains the main benefits of the current bookbuilding model, while adding transparency elements and thus incorporating both discretionary and transparency features to capture the advantages of both bookbuilding and an auction model. Finally, it is proposed in light of the lack of regulatory enforcement, that s138D of FSMA be extended to private claims in order to ensure an effective implementation of the proposed framework. The way forward should be to build upon the current bookbuilding system by incorporating new disclosure requirements and extending the enforceability of rules, in order to cure the present ailments of the bookbuilding regime.