

INSIGHT: IPO INTELLIGENCE

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I. INTRODUCTION

IPOs are about information. The policy goal is reasonably clear: to encourage the efficient flow of information so that the cost of capital for growth companies is low.¹ Investors must be able to find out information about the issuers. For lawyers involved in the deal-making process, information costs are a familiar key transaction cost to be overcome.²

But IPOs pose a special kind of information problem: they pose an intelligence problem. The Internet has decreased search costs—the costs of acquiring information.³ But the Internet has not, and cannot, solve the intelligence problem. If anything, it may make things worse—or at least pose some new challenges.⁴

The Internet makes it easier to acquire information and access markets, but it does not necessarily improve the quality of information. For that, we need good intelligence. And good intelligence comes from people, not technology. That's what I want to talk about today.

II. PUZZLES AND MYSTERIES

In an IPO, the issuer starts with all the information: information about the company, its managers, its products, its strategy for growth, its financial history, and so on. Before investors put money into a company, they need that information about the company.⁵ As a result, issuers need to find a way to feed information to investors. There is an information gap between the issuer and the investors, and it can be a little scary to cross. I want to “mind the gap” and focus in on this information gap between buyer and seller.⁶

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¹ See, e.g., Jill E. Fisch, *Can Internet Offerings Bridge the Small Business Capital Barrier?*, 2 J. SMALL & EMERGING BUS. L. 57, 64 (1998).

² See Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239, 253 (1984).

³ See Lawrence B. Solum, *Download While It's Hot: Open Access and Legal Scholarship*, 10 LEWIS & CLARK L. REV. 841, 860-61 (2006) (discussing search costs).

⁴ See Troy A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 WASH. U. L.Q. 417, 474 (2003).

⁵ See William K. Sjostrom, Jr., *Going Public Through an Internet Direct Public Offering*, 53 FLA. L. REV. 529, 551 (2001).

⁶ See generally Anita I. Anand, *The Efficiency of Direct Public Offerings*, 7 J. SMALL &

Another way to think about this gap is as an information asymmetry between issuer and investor.⁷ The issuer has superior knowledge of its financial information, strategic plans, management talent, and all of this information has to get from the issuer to the investors for the IPO to work. How exactly does this happen? It's a bit of a black box.

Regulators help define the shape of the box.⁸ They limit the kind and amount of information that companies disclose, setting boundaries on what is permissible and impermissible disclosure at certain times. In some ways the government fills the box by forcing disclosure, but to a great extent it merely coordinates the form in which that information is disclosed.⁹

To a large extent, then, we rely on the private market to generate the information that must flow to investors. But how do we know if it's the right amount of information? If markets function imperfectly, or if regulators force too much disclosure, or the wrong kind of disclosure, we might end up with too little information, or too much information, or useless information that crowds out good information. We certainly don't know for sure if we have "intelligent" information—the key information that allows investors to price securities efficiently.¹⁰ Still, this is a problem that we must tackle. One of the most important questions in finance is encouraging the efficient flow of information for new issuers, as getting it right means that we are lowering the cost of capital for growth companies. It is, in other words, the engine that spurs innovation.

But how do we go about gathering good intelligence on any sort of problem? I want to emphasize today that it's not just about gathering information, but the quality of the information gathered. And the Internet cannot help us with that as much as one might think.

For inspiration on this question I turn to one of my heroes, Malcolm Gladwell. Gladwell wrote a piece in the *New Yorker* about Enron recently. The article, titled *Open Secrets*, talks about why Enron was so overpriced.¹¹ Gladwell argues that the conventional wisdom about Enron has it wrong. Enron wasn't overpriced because it didn't disclose enough information

EMERGING BUS. L. 433 (2003) (describing varying transaction costs for new issuers vs. seasoned issuers, equity securities vs. debt securities, to institutional investors vs. individual investors).

⁷ See generally Ronald J. Gilson & Reineir H. Kraakman, *The Mechanisms of Market Efficiency*, 70 VA. L. REV. 549, 593-609 (1984) (discussing information costs).

⁸ For a nice overview of the regulatory role in a global context, see Stephen J. Choi & Andrew T. Guzman, *National Laws, International Money: Regulation in a Global Capital Market*, 65 FORDHAM L. REV. 1855, 1859-83 (1997).

⁹ See also Robert B. Adhieh, *Law's Signal: A Cueing Theory of Law in Market Transition*, 77 S. CAL. L. REV. 215, 263, 269-73 (2004) (discussing the role of the law in coordinating information flow and market participants' expectations).

¹⁰ See Gilson & Kraakman, *supra* note 7, at 565-92 (discussing mechanisms that the private market uses to achieve more efficient pricing).

¹¹ Malcolm Gladwell, *Open Secrets*, THE NEW YORKER, Jan. 8, 2007, at 44.

about what it was doing.¹² It failed because there was too much information, and Wall Street failed to focus on what was important.¹³

Gladwell drew a distinction between puzzles and mysteries. A puzzle is where you “don’t have enough information.”¹⁴ You need a little more information to solve it, one last piece of the puzzle. Tenacity is important. A mystery, on the other hand, is where you have too much information.¹⁵ To solve a mystery, you have to sift through lots of red herrings, look for clues, and deduce an answer. Intelligence is the key.

Enron, Gladwell argued, wasn’t a puzzle; “It was a mystery.”¹⁶ It wasn’t a problem of too little information. There was too much information.¹⁷ Enron was overhyped by the media, overhyped by analysts, and the noise in the data overwhelmed investors. Enron became a “faith” stock—a stock you bought not based on evidence, but because you believed in the idea.¹⁸ Was Gladwell right? What was happening in the black box between Enron and its investors? Is the black box a mystery, rather than a puzzle? The answer is complicated. It’s complicated whether Gladwell is right or not because the information inside the black box is complicated. It’s not easy to interpret. Of course, the answer is that Enron was both a puzzle and a mystery. There was too much information. But there was also a problem with the quality of the information. There was bad information; information was selectively disclosed; and it was selectively listened to.

As Jonathan Macey noted, there’s plenty of blame to go around for Enron.¹⁹ We can heap some on Wall Street for its failure to process the available information, and there’s still plenty of blame left for the auditors, the lawyers, the managers, and even the investors themselves.

In a prior essay on Enron I tried to note that while information about the gap between Enron’s taxable income and accounting income was easy to observe, the source of it was not.²⁰ Enron’s income could be low because it was investing in research and development assets, or because of regulatory

¹² *Id.* at 46.

¹³ *Id.* at 46-50.

¹⁴ *Id.* at 44-46.

¹⁵ *Id.* at 44-46.

¹⁶ *Id.* at 46.

¹⁷ *Id.* at 50 (“To [Professor Stephen] Schwarcz, all Enron proves is that in an age of increasing financial complexity the ‘disclosure paradigm’—the idea that the more a company tells us about its business, the better off we are—has become an anachronism.”).

¹⁸ See Jeffrey N. Gordon, *What Enron Means for the Management and Control of the Modern Business Corporation: Some Initial Reflections*, 69 U. CHI. L. REV. 1233, 1236 (2002).

¹⁹ See Jonathan R. Macey, *A Pox on Both Your Houses: Enron, Sarbanes-Oxley and the Debate Concerning the Relative Efficacy of Mandatory Versus Enabling Rules*, 81 WASH. U. L.Q. 329, 334-35 (2003).

²⁰ See Victor Fleischer, *Enron’s Dirty Little Secret: Waiting for the Other Shoe to Drop*, 94 TAX NOTES 1045, 1046 (2002).

gamesmanship. To figure that out, you need a different skill set than what most financial analysts use in valuing securities. While the capital markets are efficient at pricing many different kinds of business risks, I'm less convinced that they are very good at accounting for legal risk, regulatory risk, or regulatory gamesmanship.²¹

Return to the IPO question. What happens in the black box? Is there too little information for investors, or too much? Is it a puzzle or a mystery? Or is it both? How can we improve not just the amount of information, or access to the information, but the quality of the information?

Let's consider what we know about intelligence gathering more broadly. We tend to overvalue intelligence that is gathered covertly; the search for weapons of mass destruction in Iraq reminded us that covert intelligence isn't necessarily the most reliable information.²² Rather, one of the most important intelligence functions is processing the information that's out in the open.

The Internet, of course, is great at gathering large amounts of information; search costs have dropped dramatically. The key promise of the Internet when it comes to capital markets, as with other markets, is disintermediation. Whether an information seeker wants to find a mate, a book, an airline ticket, a house, a movie to watch or a blog to read, the Internet makes it easier for that to happen without the seeker's paying a substantial fee to an intermediary.

Decreasing search costs is what Google is all about, and as I wrote in *Brand New Deal*, it made perfect sense for Google to do its IPO in a different way.²³ Google took information about the company, and rather than place the stock through intermediaries through a book-building process, the price and allocation were determined by auction.²⁴ Google thought that this would lead to great efficiency as the market of disintermediated buyers would discover the right price.²⁵

But it's not so clear that it worked out this way. In the frenzy leading up to the IPO, there may have been too much information, not too little. The stock was almost certainly underpriced, jumping 18% on the first day and another 300% that year.²⁶ The first really big Internet auction failed to convey information to investors in the most efficient manner.

²¹ See Victor Fleischer, *The MasterCard IPO: Protecting the Priceless Brand*, 12 HARV. NEGOT. L. REV. 137, 152-55 (2007).

²² See Gladwell, *supra* note 11, at 44.

²³ See Victor Fleischer, *Brand New Deal: The Branding Effect of Corporate Deal Structures*, 104 MICH. L. REV. 1581, 1600-06 (2006).

²⁴ See *id.* at 1598.

²⁵ See generally Christine Hurt, *What Google Can't Tell Us About Internet Auctions (And What It Can)*, 37 U. TOL. L. REV. 403 (2006).

²⁶ See Fleischer, *supra* note 23, at 1598.

As I've argued elsewhere,²⁷ in the case of Google the structure can still be defended on efficiency grounds by looking at the branding value of the deal structure—the message conveyed to consumers. But the takeaway lesson in considering information costs is that the magic of the market is limited. Allowing numerous individual buyers to bid on the stock didn't produce an efficient pricing of the stock, just as the market didn't efficiently price Enron stock until the very end.

III. CONCLUSION: INTERMEDIARIES IN A WORLD OF CHEAP INFORMATION

No matter how cheap information gets, we will still need intermediaries. Issuers will always need to rent the reputation of underwriters and lawyers, and investors will need guidance from analysts or other intermediaries.²⁸ It's not that these intermediaries have more information, but rather that their skill sets turn raw information into information one can intelligently act on. It's not the most informed but rather the most intelligent investors who can become opinion leaders, finding the best opportunities and setting market trends.

In sum, the Internet has driven down the cost of acquiring information in every facet of life. In some transactional contexts intermediaries aren't as necessary as they used to be. But disintermediation brings with it the risk of too much information; bad information driving out the good; noise crowding out the useful information in the data. In the IPO context, we will continue to need strong, conflict-free gatekeepers—analysts, lawyers, underwriters, auditors—to help investors process the information. And regulators, too, will need to help coordinate the production of information in a disintermediated world.

The Internet can help investors find information, covertly and overtly, about the companies they want to invest in. But it cannot make investors intelligent. Technology isn't intelligent; people are.

²⁷ See *id.* at 1600.

²⁸ See Gilson & Kraakman, *supra* note 7, at 605, 620-21.