Put corruption under the hammer

It is tempting to hope that an apparently imminent global settlement with Wall Street firms, together with recent developments at the Securities and Exchange Commission, will halt the news of malfeasance and scandal emanating from corporate America.

Unfortunately, some superficial changes in the role of stock analysts and some relatively painless fines will not materially alter the incentives that created the current mess. Nor will simple changes in regulatory personnel significantly advance the ability of government to end abuses. Fundamental structural reform is needed to accomplish any real improvement.

Take one of the roots of today’s problems: the mechanism for allocating shares in initial public offerings. The share price in IPOs often bears little connection to the equating of supply with demand. IPOs are sometimes massively oversubscribed and the share price increases by as much as a factor of five from the offering price to the close of the first day of trading. Shares in these oversubscribed offerings are rationed not according to willingness to pay but to favoured clients of the underwriting investment banks.

In one famous instance, customers were required to kick back a third of their IPO trading profits to the investment bank. It seems that the payment took the form of inflated commissions on other stock trades. When an investor pays a stock-trading commission of $3 per share on a trade of 10,000 shares, one can be relatively sure that it is a kickback.

In other instances, underpriced IPO shares have become the currency for implicit rebates to executives. Sometimes it looks as though the executives may have received their personal allotments in exchange for swinging their companies’ business to the investment bank. For example, five telecommunications executives apparently received IPO shares yielding $28m in quick profits at the same time as their employers paid $240m in fees to the investment bank.

In short, it has become increasingly clear this year that the system for new security issuance is fundamentally corrupt. Periodically, regulators contemplate drafting new rules to curb the abuses associated with IPOs. But no such rule will be effective as long as new issues continue to be deliberately underpriced relative to market conditions. As long as the basic economic facts of underpricing, artificial shortage and instant profitability persist, the underwriting banks will maintain some discretion to dispense the valuable shares to parties of their choosing. And one can be certain that, regardless of the rules, the shares will be allocated in return for value received in other transactions.

Fortunately, there is a way to clean up the entire process. The current book-building procedure could be replaced by a modern, dynamic auction. The auctioneer begins by announcing a low stock price and bidders respond with electronic bids representing the quantities of shares desired. If demand exceeds supply, the auctioneer announces a higher price and bidders again respond with quantities desired. The iterative process continues until demand equals supply, concluding the auction.

An auction process would bring the new issues market into equilibrium. Access to shares would be determined by price, not by a secret quid pro quo. Indeed, an IPO auction offers the promise of all but eliminating the current underpricing. In principle, the clearing price in a well designed auction is virtually equal to the market price, so the first-day return should be essentially zero.

IPO shares would no longer be the currency for kickbacks and favours, since the instant profits and the associated scarcity would vanish. There would be no need for the government to set rules for share allotments, since the underlying incentives for abuse would be gone.

Of course, there are obstacles to IPO auctions. One is that, while an auction in advance of an IPO is allowed, current SEC rules appear to require that the bids be indicative and non-binding. Any policy requiring bids to be non-binding is clearly detrimental; for an auction to work effectively, bidders need to have real consequences. At the same time, there is no good rationale for such a requirement. So it should be feasible to get the SEC or courts to overturn the rule.

Perhaps the greatest barriers to auctions are the vested interests earning rents in the current process. The IPO auction is not a panacea. Indeed, the danger of overpromoting shares of worthless companies would remain; an auction does not eliminate the risks of hype or asset bubbles.

Yet modern, dynamic auctions have been successfully applied in many other sectors of the economy and they can eliminate the incentives behind several aspects of today’s Wall Street scandals.

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