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Underwriters Do Not Use Green Shoe Options to Profit from IPO Stock Pops

Posted by Robert Evans, Locke Lord LLP, on Friday, February 26, 2021

Editor's note: Robert Evans is a partner at Locke Lord LLP. This post is in response to a post on the Forum by Professor Patrick M. Corrigan of Notre Dame Law School.

Professor Corrigan offers a new theory about why some IPO stocks pop and others suffer steep drops—underwriters are to blame. His "principal trading theory" maintains that, contrary to accepted wisdom, overallotments and green shoe options in IPOs are used to maximize trading payoffs for underwriters. His theory is wrong. Matt Levine, in his Bloomberg column, *Money Stuff*, agrees.

As a matter of market practices and because of the SEC's Regulation M, underwriters must complete their sales, including overallotments, before the IPO stock starts trading in the market. They cannot, for these reasons, hold back and sell more shares at higher prices in the aftermarket.

Establishing a new and vibrant trading market where one never existed is a challenging task. The investors that a company doing an IPO and its underwriters seek as shareholders have lots of competing ways to invest their money. Even in the same industry as the IPO company, there are competitors with established trading markets a track record of being a public reporting company.

Transforming a privately-held venture into a NYSE- or Nasdaq-traded company involves considerable art as well as science. Underwriters are asking the investors to take on some of the risk of that launch into the unknown of public trading. The dynamics of supply and demand for the shares can influence the success or failure of the company's entering into the public markets.

And pricing the IPO and commencement of the stock trading, does not happen in a static world or marketplace. The stock will be buffeted by the same forces that cause the rest of the market to go up and down or sideways on any given day, which can be amplified by the lack of an established shareholder base.

And the underwriters cannot really know what will happen when the stock starts trading—so the idea that somehow they do know and can manipulate the issuer and the investors is unfounded.

Almost all US IPOs include overallotments and a green shoe option. The overallotment occurs when the underwriters, at the time of pricing the IPO, decide how many shares to sell at the public offering price. If they allot more shares to investors than they have committed to buy (that is, more than the "firm shares"), that's an overallotment. The issuer typically grants to the

underwriters an option to purchase additional shares (up to 15% of the firm shares) at the same purchase price, which is known as a green shoe option.

The investment banks explain that overallotments create a short position held by the underwriting syndicate. If the stock price drops after the stock begins trading on the NYSE or Nasdaq, the underwriting syndicate will be able to cover its short position by buying shares in the market, thereby providing some support for the stock price. This, Professor Corrigan dubs, the "price stabilization theory".

He then criticizes that theory—pointing out that short sales followed by repurchases are wash trades that do not inject lasting or substantial new demand into the aftermarket. He also notes that IPO stocks almost never trade exactly at the public offering price over the first two weeks of trading, that around a quarter of all IPOs trade down over those two weeks and many IPOs have dramatic price increases (a so-called stock pop) once trading commences.

Professor Corrigan points out that underwriters can profit from overallotments if the stock trades down —citing the $100 million that the underwriters made on the Facebook IPO covering their short (created by overallotments) at a price below the IPO price.

Professor Corrigan then accuses underwriters of profiting when an IPO company's stock price rises in the aftermarket. He imagines that underwriters conspire to underprice the IPO, decide not to overallot any shares and then, after the stock price pops, they sell short additional shares at the higher market prices and cover by exercising the green shoe option to capture the difference between the true value of the shares and the public offering price.

To support his theory, Professor Corrigan argues that the US securities laws do not block underwriters from selling short additional shares into the aftermarket (to later be covered with shares from the green shoe option). He observes that the adoption of Regulation M in 1997 was in some ways deregulatory and identifies a relevant no-action letter obtained by Bill Williams of Sullivan & Cromwell in 1996 relating to sales outside the US.

Based on the Professor's reading of Regulation M and the Bill Williams no-action letter, he concludes that Regulation M (exception 9 to Rule 101) does not block underwriters from selling the shares underlying the green shoe option into the aftermarket after the stock price pops. And he may well be correct about that assertion, except for one critical piece of the analysis that he omits.

The missing piece is that, once the IPO prices and the stock opens for trading, the investment banks that are acting as underwriters will begin trading the stock. Part of investment banks' business model is to maintain trading desks that make markets in equity securities. Under Regulation M, those trading desks are unable to make purchases (blocked by Regulation M) while the underwriters are still in distribution. This is particularly true for IPOs because the exemption for trading that is available for actively traded common stock does not apply in an IPO.

However, if the underwriters' trading desks do not begin trading, the investors they just sold the stock to will get nervous that something is wrong. Also, if the underwriters delay trading, some of their best customers might find another broker-dealer to trade through—undermining those customer relationships. That means there is huge pressure to complete the underwriters'

participation in the distribution before the stock market opens the morning after pricing and for the trading restrictions in the Master Agreement Among Underwriters to have terminated—i.e., the stock is free to trade.

Completion of participation in a distribution is a defined term in Regulation M that means, with respect to an underwriter:

"when such person's **participation has been distributed**, including all other securities of the same class that are acquired in connection with the distribution, and any stabilization arrangements and trading restrictions in connection with the distribution have been terminated; *Provided, however,* That an underwriter's participation will not be deemed to have been completed if a syndicate overallotment option is exercised in an amount that exceeds the net syndicate short position at the time of such exercise" (emphasis added).

If underwriters do not overallot all of the shares that are covered by the green shoe option and plan to sell those shares after the price has bumped up in trading on the stock market, they will not have completed their participation in the distribution and therefore will not be able to commence making a market in the IPO shares.

The proviso at the end of the Regulation M definition makes it clear that, even if the underwriters overallot all of the shares they are entitled to buy under the green shoe option, if they subsequently cover some of that short in the market and then exercise the full shoe, they would be considered as having been in distribution all along. Similarly, if they did not overallot all of the shares but instead sold them during the 30-day green shoe window, they would not have concluded their participation in the distribution until after they had sold those shares.

Once we see that Professor Corrigan's new theory does not reflect the actual activities of underwriting syndicates, it undercuts several of the "payoffs" he claims. For example, his theory does not explain laddering during the internet bubble. It also does not mean that Regulation M contributed to the dramatic increase in IPO stock pops during the internet bubble (even if his theory were correct, this supposed payoff would not have occurred because almost all underwriting agreements at that time still used the term "overallotment option" or "solely to cover overallotments"). Most importantly, the failure of his new theory undercuts his call for additional regulation.

The more insidious aspect of Professor Corrigan's argument is that specific new regulations are needed to police underwriting arrangements to protect "naïve" issuers. He maintains that underwriters are scheming to profit from overallotments and green shoe options at the expense of companies that want to go public. He suggests that additional regulation is required to restrain underwriter behavior.

It is true that underwriters act in their best interest while conducting IPOs and that they are economically motivated. It is also true that regulations requiring disclosures and limiting abuse can be important in limiting self-serving behavior. However, it is also important to let markets function and allow sophisticated parties to adapt to new developments in the law and in the markets. Too much regulation, particularly if sparked by unjustified concerns, can destroy value and inhibit innovation. And bottom line, additional regulation is not called for here.