

**Monetta Financial Services, Inc.\***

**Background on IPOs**

Initial Public Offerings (IPO) occur when a stock is sold to the public for the first time. In 1998 there were 395 IPOs in the United States, in which \$43.6 billion was raised. In 1997 \$44 billion was raised in 625 IPOs.

A typical firm begins its life by raising equity capital from a small circle of initial investors. While these investors hope to benefit by getting in on the ground floor, in the short run their stock holdings are illiquid because there is no public market on which they can sell their stocks. As the company grows and finds it needs more capital, it generally will “go public” by selling additional stock to a large number of diversified investors. Once the firm goes public and its stock is publicly traded, the cost of raising equity is lower because the firm does not have to compensate investors for the lack of liquidity.

**Role of Underwriters**

A firm that wishes to go public with an IPO generally hires an investment bank to assist it. The investment bank, or underwriter, helps to choose a price for the offering and develops an initial market for the stock. Underwriters (with the help of legal counsel) also carry out a due diligence investigation of the company, write the stock prospectus, and file the necessary documents with the SEC.

The underwriters first prepare an initial prospectus containing a Filing Price for the stock. This is expressed as a range within which the underwriters expect the actual price of the stock to fall. After preparing the initial prospectus, the underwriters begin a process of marketing the stock. This typically involves making presentations to prospective institutional buyers in major cities, including large purchasers such as mutual funds. During this process the underwriter collects and records potential purchases. That is, potential purchasers offer non-binding indications of how many shares they are interested in buying and at what price. The underwriters may raise or lower the suggested share price during this interval, in order to roughly match supply and demand. The subscription ratio, which is the ratio of tentative purchase orders to the total number of shares available, is used to measure the demand for the issue. For some particularly attractive stocks, the subscription ratio may be five to one (indicating five orders for every share), while for less attractive shares it may be only one to one.

This marketing phase ends when the SEC approves the stock for sale. After the market closes, the underwriter will announce the Offer Price at which it will sell the stock to interested buyers on the next trading day. (For a variety of reasons, the Offer Price is

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\* This case was developed for classroom use by Professor Stephen G. Powell of the Amos Tuck School of Business Administration, Dartmouth College. The assistance of Andrew M. Brownell and Professor Kent Womack is gratefully acknowledged.

typically set about 15% below the estimated market price, so the majority of IPOs appreciate in price during the first day of public trading). They also allocate shares to the buyers, since often the demand exceeds the supply of available shares. Thus an investment house such as Monetta that has indicated a willingness to buy to the underwriter will receive a certain number of shares of the new issue before the market opens on the first day of trading. It will then sell these shares to its own clients.

One detail of this selling process is particularly relevant. When the underwriter allocates shares to an investment adviser like Monetta, it does not require them to disclose how they plan to allocate those shares to their own client accounts. Thus an adviser can sell shares during the first day of trading and then decide which of its clients will be credited with the gain or loss between the actual selling price and the Offer Price. This arrangement is not technically permissible, but is a practical reality.

### **SEC's charge against Monetta**

The SEC has charged that Monetta knowingly allocated "hot" IPOs to its own Directors instead of to its mutual fund clients (Monetta Fund and Monetta Trust). If proven, this would be illegal because it violates Monetta's fiduciary responsibility to its clients, and because it would represent an attempt to influence the Board of Directors to view Monetta in a favorable light.

### **The Data**

During the period in question, February 1, 1993 to September 30, 1993, 379 IPOs were issued with a total value of \$32.9 billion. The average IPO during this period involved sale of 5.2 million shares (median 2.8 million), and raised \$86.6 million (median \$35.7 million). The Offer Price typically fell close to the middle of the range of prices quoted in the initial prospectus. The average appreciation when these stocks opened for trading (the difference between the Opening Price and the Offer Price) was +11.6% (median +6.7%); the worst case was a loss of 10% and the best was a gain of 69%.

During this same period, Monetta participated in fifty IPOs. The SEC has collected the following information on these new issues (the data is available in the attached table and in spreadsheet form in the sub-folder MFS):

1. *ID number* (the official CRSP number for the stock, with which it can be accessed in TuckPerk)
2. *Date of issue*
3. *Portfolio* (each issue was sold by Monetta to its regular mutual Fund customers only, to its Directors only, or to Both)
4. *Ticker*
5. *Underwriter* (name of the underwriting investment bank)
6. *Price* (offer price set by the underwriter)
7. *Shares* (millions of shares offered)
8. *Proceeds* (shares sold times offer price)
9. *Return-to-Close* (percent change between the closing price on Day 1 and the offer price)
10. *Return-to-Open* (percent change between the opening price on Day 1 and the offer price)
11. *Flipping percentage\** (the percent of shares sold in blocks of 10,000 or more on Day 1)

12. *Mid-to-offer* (percent change between the mid-point of the filing price range and the offer price)

\*Note: the flipping percentage is generally thought to reflect the judgement of knowledgeable investors in the future prospects of the stock. Trades in blocks of 10,000 or more are typically made by institutional investors, who are in a position to estimate the long-run return from holding the stock. If these investors trade on Day 1, their judgment is that the stock will go down after its initial price increase over the Offer Price.

**Assignment:**

Draft a brief that will help the SEC make its case against Monetta Financial Services.

ISSUE	ID	DATE	PORTFOLIO	TICKER	UNDERWRITER	Price
A Pea in the Pod	79566	09/23/93	Fund	APOD	ROBERTSON-S	12.000
Actel	79467	08/03/93	Fund	ACTL	GS	9.500
Allied Holdings	79591	9/29/93	Fund	HAUL	ALEX-BROWN	14.0000
ANTEC	79564	9/17/93	Fund	ANTC	DLJ	18.0000
Avid Technology	78955	03/12/93	Fund	AVID	MS	20.000
Broadcasting Partners	79569	9/28/93	Fund	BPIX	ALEX-BROWN	14.5000
Cobra Golf	79572	9/21/93	Fund	CBRA	LEH	21.0000
Coca-Cola FEMSA	79644	09/14/93	Fund	KOF	BEAR	20.500
Community Health Computing	78962	03/09/93	Fund	CHCC	MONTGOMERY	10.000
Cornerstone Imaging	79577	09/09/93	Fund	CRNR	ROBERTSON-S	11.000
CTL Credit	79079	4/28/93	Fund	CTLI	MONTGOMERY	11.0000
Envirotest Systems	79084	04/01/93	Fund	ENVI	GS	16.000
Gupta	78890	02/05/93	Fund	GPTA	MS	18.000
HomeTown Buffet	79594	09/23/93	Fund	HTBB	MONTGOMERY	15.000
Inco Homes Corp	80106	04/02/93	Fund	INHM	MONTGOMERY	10.000
Intuit	78975	03/12/93	Fund	INTU	MS	20.000
Key Technology	79399	07/23/93	Fund	KTEC	NEEDHAM	9.000
Kurzweil Applied Intelligence	79501	08/17/93	Fund	KURZ	ROBERTSON-S	10.000
Level One Communications	79503	08/19/93	Fund	LEVL	ALEX-BROWN	17.000
Life Partners Group	79061	3/25/93	Fund	LPG	DLJ	17.0000
MathSoft	78894	2/3/93	Fund	MATH	ALEX-BROWN	13.0000
Molecular Dynamics	78895	02/05/93	Fund	MDYN	HAMBRECHT	11.000
Pacific Sunwear of California	78999	03/16/93	Fund	PSUN	ROBERTSON-S	13.000
Panamerican Beverages	79662	09/22/93	Fund	PB	LAZ	25.500
PetSmart	79411	7/23/93	Fund	PETM	DLJ	18.0000
Preferred Entertainment	79520	8/5/93	Fund	PREF	GERARD-KLAUER	15.5000
QuickResponse Services	79523	8/5/93	Fund	QRSI	ALEX-BROWN	12.0000
ReSound	79002	03/04/93	Fund	RSND	MONTGOMERY	8.500
Resource Bancshares Mtg Grp SC	79188	5/26/93	Fund	REMI	MONTGOMERY	8.7500
Royal Grip	79589	9/23/93	Fund	GRIP	WM-BLAIR	12.0000
S3	79009	3/5/93	Fund	SIII	LEH	15.0000
Sonat Offshore Drilling	79237	05/28/93	Fund	RIG	GS	22.000
Southern Energy Homes	79008	03/12/93	Fund	SEHI	MONTGOMERY	13.000
Stant	79422	07/22/93	Fund	STNT	MS	16.000
Sundance Homes	79423	07/09/93	Fund	SUNH	MONTGOMERY	8.000
Ultratech Stepper	79628	09/29/93	Fund	UTEK	MONTGOMERY	14.000
Watson Pharmaceuticals	78916	02/17/93	Fund	WATS	BEAR	12.000
Powersoft	78907	02/03/93	Director	PWRS	GS	20.000
Wall Data	79024	03/16/93	Both	WALL	BEAR	20.000
Parallan Computer	78998	03/30/93	Both	PLLN	MONTGOMERY	12.000
BHC Financial	79074	04/07/93	Both	BHCF	MONTGOMERY	14.000
3DO	79197	05/04/93	Director	THDO	MS	15.000
Catalyst Semiconductor	79156	05/11/93	Director	CATS	MONTGOMERY	11.0000
Auspex Systems	79152	05/12/93	Director	ASPX	GS	12.000
Papa John's International	79299	06/08/93	Both	PZZA	MONTGOMERY	13.000
Sunglass Hut International	79300	06/09/93	Both	RAYS	MONTGOMERY	20.000
BroadBand Technologies	79371	07/01/93	Both	BBTK	BEAR	18.000
Cyrix	79377	07/16/93	Director	CYRX	MONTGOMERY	16.000
Wonderware	79429	07/23/93	Both	WNDR	MONTGOMERY	14.000
NetManage	79612	09/21/93	Both	NETM	ROBERTSON-S	16.000

Shares (mil)	Proceeds (mil)	Ret-close	Ret-Open	Flipping	Mid-Offer (%)
1.250	15.000	0.021	0.021	0.561	-14.300
4.715	44.793	0.395	0.184	0.229	0.000
3.0000	42.000	0.027	0.018	0.124	0.000
8.1500	146.700	0.333	0.333	0.232	20.000
3.220	64.400	0.313	0.250	0.200	25.000
4.0250	58.363	0.207	0.276	0.117	11.500
3.7375	78.488	0.512	0.524	0.228	10.500
9.025	185.013	0.085	0.098	0.273	13.900
2.000	20.000	0.000	0.100	0.395	-9.100
2.070	22.770	0.318	0.318	0.149	18.900
3.4500	37.950	-0.011	0.000	0.424	0.000
3.400	54.400	0.016	0.078	0.407	6.700
2.530	45.540	0.875	0.694	0.130	80.000
2.300	34.500	0.608	0.400	0.237	50.000
2.228	22.275	-0.025	0.000	0.607	-9.100
1.725	34.500	0.588	0.375	0.119	25.000
1.300	11.700	0.000	0.056	0.434	-18.200
2.100	21.000	0.125	0.225	0.315	-9.100
2.530	43.010	0.676	0.632	0.171	21.400
16.8064	285.709	0.176	0.103	0.327	6.200
2.8750	37.375	0.692	0.577	0.108	18.200
2.452	26.975	0.466	0.091	0.211	-8.300
2.070	26.910	0.212	0.269	0.204	13.000
13.225	337.238	0.078	0.059	0.252	10.900
8.2800	149.040	0.389	0.389	0.183	9.100
2.0000	31.000	0.258	0.177	0.272	55.000
4.0250	48.300	0.344	0.417	0.156	20.000
2.875	24.438	0.279	0.147	0.321	-5.600
6.3250	55.344	0.000	0.000	0.649	-12.500
1.1500	13.800	0.729	0.500	0.085	20.000
2.3000	34.500	0.317	0.317	0.170	25.000
16.948	372.849	0.006	0.000	0.788	-4.300
2.386	31.021	0.173	0.135	0.283	8.300
6.500	104.000	0.063	0.063	0.503	6.700
3.105	24.840	0.047	0.141	0.510	-27.300
2.530	35.420	0.339	0.375	0.243	16.700
4.140	49.680	0.188	0.063	0.306	0.000
2.145	42.895	0.913	0.688	0.081	33.300
2.880	57.600	0.138	0.250	0.186	33.300
2.588	31.050	0.000	0.125	0.302	9.100
2.442	34.192	0.339	0.268	0.174	0.000
3.335	50.025	0.350	0.233	0.153	36.400
3.4500	37.950	0.227	0.205	0.242	10.000
5.750	69.000	0.198	0.292	0.245	9.100
1.668	21.678	0.346	0.385	0.170	18.200
4.649	92.976	0.213	0.363	0.215	21.200
4.025	72.450	0.556	0.431	0.163	12.500
2.300	36.800	0.297	0.234	0.150	14.300
3.450	48.300	0.214	0.321	0.239	27.300
2.530	40.480	0.516	0.656	0.154	60.000

