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IPO OUTLOOK

New 'Friends and Family' Plan: Cut Them Out

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Friends and family are getting the cold shoulder.

"Friends and family" stock-buying programs, a signature feature of the late '90s Internet boom, enable companies pursuing initial public offerings to let their employees, customers and others buy shares before their potential rise in the broader market.

They are seen as a way to build loyalty among employees and other share recipients, and can help bolster demand for an IPO if institutional investor interest proves weak.

But in recent years, a declining percentage of companies have offered friends-and-family shares, known as a directed-shares program, and this year has seen a sharp drop.

Bankers and company executives say factors behind the decline include legal headaches of such offerings, as well as rules under the newly enacted JOBS Act, a new law aimed at helping startup companies raise capital for expansion and hiring.

Another concern, they say: relatively poor performance of some IPOs makes insiders hesitant to put people close to them at risk. The average U. S-listed company IPO this year is up 18% in its first month of trading, compared with a one-month gain of 56% for IPOs in 2000, according to data firm Dealogic.

Nearly half of company IPOs listed in the U.S. in 2010 and 2011 included directed-share programs, and nearly two-thirds of deals a decade ago included them. So far this year, about 33% have used these programs, according to Ipreo, a capital markets data and advisory firm. That is the lowest percentage in at least a decade.

Several of this year's high-profile IPOs, including social network Facebook Inc. FB -1.34% and Internet business software firms Palo Alto Networks Inc. PANW -0.07% and Splunk Inc., SPLK +0.77% didn't have directed-shares programs for their deals.

However, software-maker Workday Inc. WDAY -2.23% and Realogy Holdings Corp., RLGY +0.88% owner of Realtor brands such as Century 21, did offer such programs.

Workday, Realogy, Facebook and Palo Alto Networks declined to comment.

Tom Murphy, head of the securities and capital markets group at the law firm McDermott Will & Emery LLP, said he doesn't recommend directed-share programs to issuers because generally they are no longer worth the logistical and other hurdles they present.

"You offer [shares] to employees, they feel like they should buy them, but aren't happy if [the shares] don't go up," he said.

"Underwriters don't like them, it's less they can sell," he added. "There are more and more decisions about what to disclose. In most instances, they're not worth the headache."

Some executives point to the Jumpstart Our Business Startups Act as another reason for the decline.

A provision of the JOBS Act allows companies with revenues under $1 billion to have earlier discussions with potential investors about buying their stock before the IPO.

This helps them size up whether they need to rely on employees and friends to reach a fundraising target, executives and advisers say.

Richard Eisenstadt, chief financial officer of pharmaceutical company Tranzyme Inc., TZYM -3.47% said his firm used a directed-share program in its $57 million IPO in 2011 to gain support seen as potentially necessary to help Tranzyme meet its money-raising target.

Before the IPO, "we didn't know where a single dollar was going to come from," said Mr. Eisenstadt.

But he said that if the company had done the IPO under the JOBS Act, it might not have enlisted the help of employees to raise money, as it later discovered there was sufficient investor interest.

These programs came under scrutiny after the dot-com bust in 2000. An industry panel in 2003 recommended limiting the size of offerings and increasing disclosure about them, to avoid such programs from being "misused or overused," which the panel said could "compromise the IPO process." For example, a company might underprice its IPO to get a bigger pop for insiders.

Yet there is some evidence these IPOs don't perform any differently than others. A study at Indiana University's Kelley School of Business of IPOs from 1999 to 2003 found there was no relationship between the use of directed-share programs and shares being offered at unusually low prices.

Even the companies that go ahead with directed-share programs appear to be curbing the offerings. In the late 1990s, deals that included directed-shares programs typically dedicated around 10% of the offering to the program, according to the 2003 industry panel. This year, the average was 5%, according to Ipreo.

Some companies still use the programs to reward individuals close to the business without having to incur the expense of giving options, said Dave Alberga, executive chairman of Active Network Inc., a Web-based platform for managing large events.

He said his company used a directed-shares program for employees in its 2011 IPO, though it limited participation to a percentage of their income.

"You don't want…friends or family buying shares based on a belief there will be a windfall," he said. "We struck a balance to let employees come in with a small amount, and hopefully that was perceived as a benefit."

Mr. Alberga said he declined advice to offer the stock to customers. "It sounded to me like it was logistically difficult, and I didn't want people rushing on something we thought would be speculative," he said.

Godfrey Sullivan, chief executive of Splunk Inc., which went public earlier this year, said that his company didn't use a directed-share program because it was too difficult to manage the process of deciding who got the shares and who didn't.

"Splunk decided that the DSP was not attractive from an image or a cost point of view," Mr. Sullivan said.