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Do investment banks compete in IPOs?: the advent of the "7% plus contract"☆

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Abstract

The large number of initial public offerings (IPOs) with a 7% spread suggests either that investment bankers collude to profit from 7% IPOs or that the 7% contract is an efficient innovation that better suits the IPO. My tests do not support the collusion theory. Low concentration and ease of entry characterize the IPO market. Moreover, the 7% spread is not abnormally profitable, nor has its use been diminished by public awareness of collusion allegations. In support of the efficient contract theory, banks

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compete in pricing 7% IPOs on the basis of reputation, placement service, and underpricing.

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1. Introduction

The frequency with which a 7% spread is used in initial public offerings (IPOs) has risen dramatically, from six in 1981 to hundreds per year in the 1990s. A spread is the underwriting syndicate's fee as a percentage of the proceeds. In this paper I empirically investigate two theories for the convergence on 7%. The cartel theory asserts that there is collusion in the IPO market to maximize profit from the 7% spread. The efficient contract theory asserts that the 7% IPO is the survivor of competition that determines the fittest IPO contract. To date, there are no empirical tests of either theory.

Theoretically, collusion in the IPO market will be either explicit or implicit, both of which require the expected gains from continuing to charge 7% to exceed the gains expected from defection. In explicit collusion, many employees from several banks jointly agree to fix the spread at 7%. Chen and Ritter (2000) favor implicit collusion by independent bankers. Their paper has inspired a class action lawsuit against 27 banks for not competing on price, as well as a U.S. Department of Justice investigation of "alleged conspiracy among securities underwriters to fix underwriting fees".[1] They relate their claim to the Christie and Schultz (1994) claim of implicit collusion among dealers to avoid odd-eighth bid–ask spreads for Nasdaq stocks, and the stunning evidence in Christie et al. (1994) of a significant drop in bid–ask spreads when that collusion claim became public. They rely on Chen (1999), who adapts Dutta and Madhavan's (1997) model of implicit collusion among dealers to apply it to IPO investment bankers.

Empirically distinguishing between the two types of collusion can be problematic because they often produce observationally similar outcomes. My tests focus on establishing whether collusion can be rejected or whether competition can be rejected. If these tests, which are often independent, reveal evidence of collusion, then more testing could be called for to determine the collusion type.

[1] Stories about the lawsuit and the investigation are found in "Allegations parallel new academic study" (Dow Jones News Service, November 4, 1998), "Coincidence or collusion? Two academics question the standard 7% IPO fee" (Business Week, November 9, 1998, p. 163), "Lawsuit accuses 27 firms of fixing fees for IPOs" (Wall Street Journal, November 11, 1998, C22), and "IPO firms face probe of 7% fee – U.S. Antitrust group questions a standard" (Wall Street Journal May 3, 1999, C1).