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The influence of lock-up provisions on IPO initial returns: Evidence from an emerging market

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ABSTRACT

A lock-up agreement ensures that major shareholders retain significant economic interest in the companies following the IPOs. Rationally, these insiders will not adhere to the lock-up agreement unless the benefits of doing so can more than offset the costs. Therefore, in an environment characterized by high information asymmetry, a lock-up agreement can serve as an effective mechanism to signal the risk or quality of firms. This article examines whether the lock-up ratio and lock-up period affect the initial returns, using a sample of 384 IPOs listed on Bursa Malaysia between 2000 and 2012. The results of the cross-sectional multiple regression show that the lock-up period is significantly positive in explaining IPO initial returns, but the lock-up ratio is not. The findings provide new insights for testing the signaling content of lock-up provisions, particularly in a setting characterized by high information asymmetry.

1. Introduction

For decades, the literature on initial public offerings (IPOs) has been devoted to establishing evidence of the anomalous initial returns on the newly issued shares. The evidence has been found to be so persistent as well as prevalent in numerous stock markets including Malaysia that IPO

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underpricing has been widely accepted as a universal phenomenon. The next wave in the IPO literature exhibits a considerable research effort devoted to finding explanations for the anomalous behavior in the immediate IPO aftermarket. Among the theoretical models that continue to obtain the most proponents are the adverse selection and signaling hypotheses, which are rooted in information asymmetry. The unequal distribution and communication of information between insiders (owners and management) and potential investors is a significant feature of the IPO firms because, prior to the IPO, these formerly privately held firms are not required to disclose their information to the public. Upon the exercise of an IPO, investors have the chance to reduce information frictions by paying attention to the information provided by the issuer in the prospectus, especially information in which disclosure is required by the market regulator.

Paradoxically, few studies concentrate on the impact of the information provided by IPO issuers in the prospectuses on initial returns (Bhabra and Pettway, 2003), even if the topic is as important as lock-up provision. It is undeniably reasonable to suspect that investors' cognitive ability can be clouded easily by the volume of information disclosed in the prospectus. In short, investors need to be selective in deciding which information is relevant in influencing the value of the IPO. Effective May 3, 1999, lock-up (share moratorium) has been made mandatory for certain issuers of IPOs in Malaysia. This makes the case in the Malaysian IPO market different from those in the US and the UK, where the lock-up arrangement is implemented on a voluntary basis based on negotiations between the investment bank and insiders of the IPO companies (Corhay et al., 2002; Mohan and Chen, 2001).

Lock-up provisions are in fact imposed in many other markets, including the MENA countries. However, the average lock-up period in those markets is normally longer than the minimum requirement (Hakim et al., 2012). In contrast, all IPO issuers in Malaysia stick to the mandatory lock-up period imposed by the regulator, while being more concerned about the lock-up ratio, that is, the percentage of shares that are prohibited from being sold, disposed, and/or transferred during the lock-up period. Even though the Securities Commission (SC), the Malaysian securities market regulator, only requires a certain minimum lock-up ratio, interestingly, most of the issuers voluntarily agree to a higher lock-up ratio.

The present study attempts to bridge the research gap stipulated by Bhabra and Pettway (2003) by examining the role of one aspect of the voluminous important information disclosed in issuers' prospectuses, namely lock-up provision. Mohan and Chen (2001) and Brav and Gompers (2003), who examine the information content of lock-up provisions in IPOs, define a lock-up provision as a prohibition from selling, disposing, and/or transferring shares for existing shareholders within a specific period of time after the IPO listing date. In the context of Malaysian IPOs, a lock-up provision (legally referred to as a share moratorium) is implemented to legally restrict major shareholders (or promoters) of the issuing firms from selling, disposing, and/or transferring all or a certain percentage of their shares within a certain period.

The present study focuses on lock-up provision in Malaysia primarily because this important provision has not received the deserved empirical attention (Wan-Hussin, 2005) despite the emphasis placed upon lock-up provisions by the Securities Commission. Commencing on May 3, 1999, lock-up provision has been made mandatory for the major shareholders of most issuing companies, and ever since then it has undergone several amendments during the study period alone (in 2003, 2008, and 2009). The latest revisions in 2009 are apparently the most restrictive and vigilant, reflecting the effectiveness of this provision as a mechanism for protecting investors' interests. The fact that the market regulator has incessantly been upgrading the lock-up provisions motivates the present study to establish empirical evidence of the role of such market structural changes in explaining the most puzzling phenomenon in IPOs, namely initial returns.

The present study differs from Wan-Hussin (2005) in three ways. First, Wan-Hussin (2005) examines a period that partially includes the first few months after the introduction of the mandatory lock-up regime for IPOs, but the regulatory change is not incorporated into his analysis. Second, unlike Wan-Hussin (2005), who uses the ratio of directors' shares that are locked, the present study takes the actual number of shares locked by the major shareholders who are actually identified as promoters of the issuing companies by the SC. Third, the present study examines lock-up provisions not only from the lock-up ratio, but also the lock-up period dimension.