



# On the uniformity of investment banking spreads: the seven percent solution is not unique

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## Abstract

The clustering of underwriting spreads for initial public offerings at 7% in the U.S. is well known. We investigate investment bank gross spreads for Hong Kong IPOs during 1991–2000 and find pronounced clustering—nearly 94% have spreads of exactly 2.5%. This clustering is invariant to issue size and decreases through time. We find that SEO spreads cluster as well—at 2.0 and 2.5%. We document institutional features that contribute to the low level of spreads, and provide preliminary evidence that the recent arrival of the book-building process for Hong Kong IPOs has increased the level and decreased the clustering of IPO gross spreads.

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## 1. Introduction

In the United States, the gross spreads paid to investment banks in initial public offerings (IPOs) of equity cluster at 7% (Chen and Ritter, 2000; Hansen, 2001; Barondes et al., 2000).<sup>1</sup> Chen and Ritter (2000) show that this clustering, which is

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<sup>1</sup> Gross spread is measured as the difference between the proceeds per share to the IPO firm and the offer price; expressed as a percentage, the difference is divided by the offer price.

prevalent only for moderate sized (20–80 million USD) IPOs, has become more widespread in recent years. They further claim that, taken collectively, this predominant clustering of IPO fees, the fact that the levels of the fees are about double what investment banks charge in many foreign markets (see also [Ljungqvist et al., 2001](#)), and that there is very little clustering of seasoned equity offering (SEO) fees suggest collusion among the investment banks in the market for IPO underwriting.

We demonstrate that the clustering phenomenon in the U.S. is not unique, nor is it the most extreme case of uniformity of investment banking fees. We examine the investment banking gross spreads for IPOs in Hong Kong and find surprising evidence that both supports and contrasts with the ‘seven percent solution’ identified by Chen and Ritter. For our sample of 306 IPOs in Hong Kong from January 1991 to December 2000, we find that the gross spreads cluster at 2.5%, far below the 7% that is common in the U.S. Further, the degree of clustering is much more pronounced in Hong Kong. Investment banks receive commissions of exactly 2.5% in nearly 94% of IPOs in Hong Kong, and this clustering is invariant with respect to issue size, and in contrast to Chen and Ritter’s findings, slightly decreases through time.

We also examine 119 SEOs in Hong Kong over the same period and find that SEO gross spreads cluster at two numbers, 2 and 2.5%. The clustering pattern of SEO gross spreads in Hong Kong is also largely invariant with respect to time, though smaller SEOs are more likely to have gross spreads of 2.5 than 2%.

The clustering in Hong Kong is interesting for several reasons. First, there are substantial fixed costs to an IPO (see [Ritter, 1987](#); [Altinkiliç and Hansen, 2000](#); [McGuinness, 1999](#)), and in a competitive market we would expect an inverse relation between gross spreads and issue size. But in Hong Kong, gross spreads are almost invariantly 2.5%, regardless of issue size. Second, the frequency of 2.5% spreads slightly decreases throughout our sample period, which contrasts with Chen and Ritter’s findings for the U.S. and [How and Yeo’s \(2000\)](#) findings for Australian IPOs.<sup>2</sup> While these findings are consistent with investment banks being able to successfully collude to fix prices, the price at which they have settled, 2.5%, is substantially lower than that received for comparable deals in the U.S. Finally, the clustering pattern in SEOs spreads presents another contrast to U.S. markets.<sup>3</sup>

Our results can be summarized as follows: (i) spreads cluster in Hong Kong; (ii) clustering in Hong Kong is more prevalent and occurs at a lower absolute level than in the U.S.; and (iii) in contrast to the U.S., clustering in Hong Kong extends to SEOs as well. In [Section 3](#), below, we discuss several features of the investment banking process in Hong Kong that contribute to these low spreads such as other

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<sup>2</sup> [How and Yeo \(2000\)](#) show that the gross spreads for Australian IPOs do not cluster at any particular level. Similarly, [Kryzanowski and Rakita \(2001\)](#) find only modest clustering of gross spreads for Canadian IPOs at 6%.

<sup>3</sup> Our findings complement those of [Torstila \(2001\)](#). Torstila examines clustering of IPO gross spreads in 27 countries, and notes clustering in Hong Kong consistent with our results, but he does not examine how clustering changes through time nor the clustering of SEO gross spreads.

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