Available online at www.sciencedirect.com
ScienceDirect

Journal of Financial Economics 85 (2007) 39–65

JOURNAL OF Financial ECONOMICS

www.elsevier.com/locate/jfec

Executive stock options and IPO underpricing☆

Michelle Lowry[a,*], Kevin J. Murphy[b]

[a]Smeal College of Business, Penn State University, University Park, PA 16802, USA
[b]Marshall School of Business, University of Southern California, Los Angeles, CA 90089, USA

Received 22 December 2005; received in revised form 5 May 2006; accepted 26 May 2006
Available online 2 March 2007

Abstract

In about one-third of US IPOs between 1996 and 2000, executives received stock options with an exercise price equal to the IPO offer price rather than a market-determined price. Among firms with such "IPO options", 58% of top executives realize a net benefit from underpricing: the gain from the options exceeds the loss from the dilution of their pre-IPO shareholdings. If executives can influence either the IPO offer price or the timing and terms of their stock option grants, there should be a positive relation between IPO option grants and underpricing. We find no evidence of such a relation. Our results contrast sharply with the emerging literature on managerial self-dealing at shareholder expense.

JEL classifications: G24; G32; J33

Keywords: Initial public offering; IPO underpricing; Executive compensation; Stock options

1. Introduction

More than two thousand US firms went public through initial public offerings (IPOs) between 1996 and 2000, generating average first-day returns of 42%. Many explorations of IPO underpricing have focused on who gains and who loses from pricing the IPO

☆We would like to thank Laura Field, David Haushalter, G. William Schwert (the editor), Ajai Singh, John Wald, and especially Jay Ritter for comments on this paper. We also thank Alexander Ljungqvist for providing data, and Laura Barrante, Eric Fricke, Douglas Gardner, Karin Lee, and Lauren Roane for research assistance.
*Corresponding author.
E-mail address: mlowry@psu.edu (M. Lowry).

0304-405X/$ - see front matter
doi:10.1016/j.jfineco.2006.05.006

significantly below the closing market price on the first trading day.[1] Gainers include initial IPO investors (such as institutions and invited participants in "family and friends" programs), while losers include pre-IPO shareholders who either sell shares in the offering significantly below their market value or suffer substantial dilution on the shares they continue to hold. Indeed, between 1996 and 1998, the average IPO left $15 million "on the table," meaning the average company would have raised $15 million more if it had been able to sell its shares at the first aftermarket closing price, rather than at the offer price. In 1999 and 2000, average money left on the table increased to almost $80 million.

The purpose of this paper is to examine another set of winners from IPO underpricing: executives receiving stock options on the IPO date with an exercise price set equal to the offer price, rather than the closing market price on that date. As we document below, such options (henceforth referred to as "IPO options") were granted to top executives in approximately one-third of US IPOs between 1996 and 2000. Executives granted IPO options are effectively receiving options granted "in-the-money" by the amount of the IPO underpricing. However, although in-the-money by the close of the first trading day, IPO options are treated as "at-the-money" for accounting, disclosure, and tax purposes.

Several recent studies have proposed that executives influence the terms of their compensation packages to their personal advantage. For example, Yermack (1997) provides evidence that executives influence the timing of their stock option awards, receiving at-the-money options just prior to releasing news that increases company stock prices.[2] Bebchuk, Fried, and Walker (2002) and Bebchuk and Fried (2003, 2004) argue that the practice of granting options at-the-money (rather than out-of-the-money or with exercise prices indexed to market movements) reflects the influence of rent-seeking managers trying to maximize their compensation in ways that are largely camouflaged to investors and the public. The benefit to executives of receiving options with an exercise price equal to the offer price (rather than the post-IPO market price) is substantial, and the fact that IPO options are treated as being granted at-the-money camouflages their cost. Therefore, to the extent that company executives can, indeed, influence the terms of their stock option arrangements, we expect IPO options to be granted more often and in larger quantities when the anticipated underpricing is high.

Recent studies have also indicated that executives influence IPO offer prices and that cross-sectional differences in IPO underpricing are explained in part by managerial incentives to set low prices. For example, Ljungqvist and Wilhelm (2003) find that underpricing is positively related to the proportion of IPO shares offered to families and friends of company employees, and they interpret this result as reflecting managerial influence over the offer price.[3] A problem with this test of the managerial-influence hypothesis is that many family and friends shares are allocated to lower-level employees or affiliates of the company who arguably have no input into the IPO offer price. In contrast,

[1]See, for example, Habib and Ljungqvist (2001), Loughran and Ritter (2002, 2004), Ljungqvist and Wilhelm (2003), Li and Masulis (2006).

[2]In a similar vein, Aboody and Kasznik (2000) provide evidence that executives manipulate the timing of news announcements so that negative news is released before an option grant, while positive news is delayed until just after an option grant.

[3]Ljungqvist and Wilhelm also find that underpricing is negatively related to the CEO's fraction of pre-IPO ownership. Because managers holding significant pre-IPO shares lose from IPO underpricing, this seems consistent with managerial influence over offer prices. However, this relation is only significant for Internet firms. We discuss this finding further in Section 5.