J. Finan. Intermediation 24 (2015) 283–311

Contents lists available at ScienceDirect

J. Finan. Intermediation

journal homepage: www.elsevier.com/locate/jfi

Share auctions of initial public offerings: Global evidence

Ravi Jagannathan [a,d,e,*], Andrei Jirnyi [b], Ann Guenther Sherman [c]

[a] *Northwestern University and National Bureau for Economic Research, United States*
[b] *Northwestern University, United States*
[c] *DePaul University, United States*
[d] *Indian School of Business, India*
[e] *Shanghai Advanced Institute of Finance, China*

A R T I C L E I N F O

Article history:
Received 10 November 2013
Available online 16 May 2014

Keywords:
Sealed bid auction
Winner's curse
Initial public offering
IPO
IPO auction
Common value auction

A B S T R A C T

While a number of countries have tried the use of sealed bid share auctions for initial public offerings (IPOs), few continue to use them. This is a puzzle, since auctions have been successfully used in a variety of situations for other financial securities, particularly for the sale of government bonds. We provide an explanation for this puzzle: Bidding in sealed bid auctions for new issues is complex, particularly when the underlying shares are difficult to value and the auction is open to large numbers of potential bidders, some of whom might be naïve. Participation fluctuations make it difficult for even sophisticated bidders to shave accurately for the winner's curse, and mistakes by some bidders impose costs on all. Our findings suggest that a hybrid auction mechanism that limits participation in the auction tranche to sophisticated investors, along with a non-competitive tranche that is open to all investors, can reduce such mistakes while at the same time providing the necessary incentives for information gathering.

* Corresponding author.
E-mail addresses: rjaganna@kellogg.northwestern.edu (R. Jagannathan), a-jirnyi@northwestern.edu, a-jirnyi@kellogg.northwestern.edu (A. Jirnyi), ann.sherman@depaul.edu (A.G. Sherman).

http://dx.doi.org/10.1016/j.jfi.2014.04.006
1042-9573/

1. Introduction

Bringing an initial public offering (IPO) to market requires a process that would determine who would be the initial investors, how many shares each of them would obtain, and what price they would pay. The standard methods include book building, fixed price public offers, and auctions, as well as their various hybrids.

In the United States, the primary method is book building, which gives the underwriter substantial discretion over allocations. However, when agents are given discretion, there is always the potential for abuse, and the numerous scandals following the internet bubble suggest that such abuses have occurred in practice.[1]

In comparison, sealed bid auctions are relatively more transparent, giving little discretion to the auction administrator, and are consequently less subject to manipulation and abuse.[2] Moreover, the auction method is old and well established, and has been particularly successful for US Treasury securities and other government debt instruments. It is also used for other securities such as Credit Default Swaps and preferred stock issues.[3] Not surprisingly, it is often suggested that auctions are a superior method of IPO placement.[4] Nevertheless, to this day the vast majority of US IPOs have followed the book building scheme, and book building has become the dominant method internationally, as we will show.

In order to explain this phenomenon, a number of explanations have been proposed in the academic literature. For example, Sherman and Titman (2002) and Sherman (2005) argue that the greater control and flexibility of the book building method and the discretion that comes with it, under certain conditions, provide substantial benefits for the issuers who are interested in choosing a particular level of underpricing to induce the desired amount of information gathering and price discovery by potential investors.[5] However, given the great variety of IPOs, it seems plausible that such conditions would be less than universally prevalent – e.g. one may expect that information production considerations would be less important in cases when rewarding price discovery is particularly costly. Thus, the low popularity of auctions in the US is somewhat of a puzzle. Unfortunately, the rarity of US IPO auctions makes this puzzle difficult to investigate. In addition, it is unclear if the US situation is a result of some unique local circumstances, or is prevalent across markets.

In this paper we provide a comparative review of international IPO practices and the factors that influence the choice of the IPO mechanism from the three most common types of IPOs. In Section 2 we offer evidence on overall usage patterns – first listing the many countries that have tried and abandoned the auction method, and then examining IPO auction outcomes in more detail. We find that, when standard auctions have had to compete with another method – either with fixed price public offers or with book building – auctions have lost out: of the 50 countries that we examine, at least half have used the auction method at some point, yet IPO auctions are still in use only in the US, where usage has been sporadic and relatively rare, and in Vietnam and possibly Israel, where there are (or until recently have been) restrictions preventing the use of book building.

We also present empirical evidence suggesting that the rarity of auction IPOs is not explained either by the lack of familiarity among issuers or by differences in underwriting fees. For example, auctions have initially been quite popular in many countries, and the fees for fixed price public offers in most of them have been the same as those for auctions, leaving investment banks with no incentive

[1] Ritter (2011) discusses the CLAS controversies: Commissions for IPOs, Laddering, Analyst conflicts of interest and Spinning. See also Loughran and Ritter (2004) for discussion of the scandals and overall trends in IPO underpricing, and Ritter and Welch (2002), Ljungqvist (2007), Wilhelm (2005) for reviews of the academic IPO literature.

[2] However, see Wilson (1979) and subsequent research on bidder manipulation in share auctions.

[3] See Chernov et al. (2011) for a detailed analysis of CDS settlement auctions. Preferred stock auctions have been used in the UK, particularly for government owned utilities. In the six month period from October 1, 1974 to March 31, 1975, all seven preferred stock issues in the UK used "Offers for Sale by Tender", i.e. auctions. The issuers were all local waterworks or water companies.

[4] Examples include "IPO Market Comes Back to Life", by Rachel Emma Silverman. Wall Street Journal, New York, N.Y.: November 11, 2003. pg. D.1. "Dutch auction IPO scheme grabs insider interest", The Red Herring (www.redherring.com), October 30, 2003. "BofI Holding Has Textbook Auction IPO", 15 March 2005, Dow Jones News Service. In fact, some have even argued that US issuers should be forced to use auctions (see for example, "The Value of Trust," Economist Staff, The Economist, June 07, 2002.) The US Securities and Exchange Commission asked for public comments on whether issuers should be forced to use auctions, since few have so far been willing to use them voluntarily. Forced action usage has been tried in, for example, Japan, Israel, and Vietnam.

[5] See also Benveniste and Spindt (1989) and Benveniste and Wilhelm (1990).