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# Does Rule 10b-21 increase SEO discounting?

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ABSTRACT

Short sale constraints prior to seasoned equity offers, imposed by Rule 10b-21 in 1988, are believed to compromise pricing efficiency and contribute to the large temporal increase in offer price discounting. This study provides additional insights by examining shelf-registered offers, which were exempt from pre-issue short sale constraints until 2004. The results suggest that pre-issue short sale constraints do not influence the level of discounting in seasoned equity offers. Moreover, this study reports that the recent temporal increase in discounting is due to a greater prevalence of overnight shelf offers, which are associated with relatively large offer price discounts.

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## 1. Introduction

In August 1988 the Securities and Exchange Commission (SEC) adopted Rule 10b-21, which prohibits short sellers from covering short positions with shares purchased in a seasoned equity offering (SEO) if the position was established between the filing and offer dates.[1] The prevailing wisdom in the literature is that Rule 10b-21 increases SEO discounting.[2] This is suggested by the theory of Gerard and Nanda (1993) and supported by the evidence in Corwin (2003) and Kim and Shin (2004). In the model of Gerard and Nanda (1993) the offer price depends on pre-issue order flow and is set before bidding begins. An informed investor with positive information about firm quality can manipulate order flow by disguising his information through a short sale. This strategy obscures the informativeness of pre-issue

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[1] In 1997 the Securities and Exchange Commission (SEC) replaced Rule 10b-21 with Rule 105 of Regulation M, under which the restricted period is limited to the five business days prior to the offering. For expository purposes, the rule is referred to as Rule 10b-21 throughout the paper.

[2] Discounting is typically calculated using the prior day's closing price as the reference point (Loderer et al., 1991; Safieddine and Wilhelm, 1996; Altinkilic and Hansen, 2003) and reflects the reduction of the offer price from the prevailing market price.

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order flow and increases information uncertainty, which increases SEO discounting and enables the manipulative investor to obtain cheaper new shares. Although Rule 10b-21 is designed to curb this strategy, Gerard and Nanda (1993) argue that the rule is likely to have the unintended effect of increasing SEO discounting because it erodes market efficiency by limiting informationally motivated short sales in addition to manipulative short sales.

These arguments raise a number of questions from an economic standpoint. First, they hinge on manipulative investors' ability to obtain shares in the offering. In practice share allocations are not always guaranteed. Second, manipulative short selling does not necessarily lead to greater discounting despite the uninformativeness of pre-issue order flow if underwriters also use information collected in the bookbuilding process to price the offer. This is because manipulative investors reveal their positive information by expressing their interest to purchase new shares, which could increase demand for the issue and place upward pressure on the offer price. Third, Rule 10b-21 is specific in that it only prohibits the covering of short positions with shares obtained in the offer. This curbs manipulation by informed short sellers that have favorable information, but arguably has less effect on informed short sellers that have negative information (i.e., non-manipulative short sellers) since it is unlikely that an investor would participate in the offer when he believes the stock is overvalued.[3] These reasonable concerns motivate further tests of the hypothesis that Rule 10b-21 increases SEO discounting.

This study provides novel evidence from an insightful new test of the hypothesis that Rule 10b-21 increases SEO discounting. The evidence rejects this hypothesis. More specifically, this paper examines the impact of Rule 10b-21 on shelf-registered offers, which came under the rule's purview in September 2004 after previously being exempt.[4,5] Shelf offers exhibit a slight *decrease* in discounting after the regulation takes effect. During the 2 years prior to the regulation the average offer price discount in shelf-registered offers is 3.50% and during the subsequent 2 years the average discount is 2.87%. This evidence suggests that the SEC's implementation of pre-issue short sale constraints for shelf offers does not have the unintended consequence of greater discounting.

The paper addresses the concern that the findings are due to a market-wide effect. This concern is reasonably ruled out. In particular, I use traditional SEOs as a control sample because they already fall under the purview of the regulation and are prevalent in the surrounding years. I employ a difference-in-difference methodology that compares the difference in discounting in shelf offers before and after the rule to the difference in discounting in traditional SEOs before and after the rule. The difference of these two differences provides an estimate of the regulation's impact on shelf offers. The results suggest that the regulation has no differential impact on the discounting of shelf offers relative to traditional SEOs, ceteris paribus.

The results are robust to additional tests. First, I re-examine the impact of the initial 1988 adoption of Rule 10b-21 using rule-exempt shelf offers as a control group. The rule appears to increase discounting in shelf offers by approximately the same amount that it increases discounting in traditional offers, despite the shelf exemption. This suggests that the model is not fully accounting for the temporal increase in discounting, causing the regression estimates to overstate the impact of Rule 10b-21. Second, I use a regression framework that accounts for the fact that there are two rule adoptions staggered over time. The estimations include an indicator that equals one for offers that are subject to the

[3] The SEC has charged investors with violating Rule 10b-21. However, there is no evidence that these are informed traders trying to manipulate prices. They could be uninformed speculators trying to profit from the difference in the secondary market price and the issue price.

[4] The primary reason for the shelf offer exemption in 1988 was that, according to the SEC, shelf offers were not as susceptible to manipulation as traditional offerings since potential investors were generally not aware of a shelf offering until immediately prior to its occurrence and thus pre-offer short sales were not focused on the prospective offering. However, the increased frequency of shelf offers in the 1990s and 2000s prompted the SEC to reevaluate the shelf exemption. In July 2004 the SEC adopted a regulation to remove the shelf exemption, effective September 7th, 2004, and in a public release stated that "today shelf offerings have many characteristics of non-shelf offerings [...] and thus investors often have notice of a shelf offering before it occurs" and that "using offering shares to cover short sales effected prior to pricing of a shelf offering has the same negative effect as in non-shelf offerings. In light of the increased use of shelf offerings, we believe that the shelf exception presents an increased potential for the type of manipulative conduct that [Rule 10b-21] is designed to prevent" (SEC Release No. 34-50103).

[5] Shelf offers are important to understand from an economic perspective because they have recently gained enormous ground in the market for seasoned equity. In the 3-year period, 2004–2006, $51 billion of stock has been offered via 317 shelf offerings, compared to only $18 billion offered via 146 traditional offerings, based on all offerings that meet the sample criteria.

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