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Equity issues and the impact of lead manager affiliation on broker market share and trading volume

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ABSTRACT

This paper studies the trading volume and market share of brokers around seasoned equity offerings (SEOs) in the Australian equity market based on a unique broker ID dataset. We examine the drivers behind the behaviour of affiliated and unaffiliated brokers around SEOs. The findings contribute to the understanding of how broker affiliation impact SEO trading activity. Results show that SEO affiliation is positively related to broker trading volume and market share on both the announcement day and issuance day. However, there is no evidence suggesting that lead managers or co-manager generate additional trading volume compared to other co-underwriters. Broker reputation, market capitalization and relative SEO size of the offering firm are shown as the primary determinants influencing broker trading activity.

1. Introduction

Given that seasoned equity offerings (SEOs) are widely regarded as one of the most important capital structure events for listed companies, a considerable amount of research has been dedicated to examine capital markets around SEOs. Masulis and Korwar (1986) state two major motivations for SEOs: first, to reduce a firm's leverage by increasing the equity component of its capital structure; second, to finance new capital expenditures, such as major expansions or acquisitions. The purpose of SEOs could also reflect the performance or financial health of a company. Therefore, investors may infer information and adjust their expectations regarding the future performance of the firm. As a result, abnormal trading activity is commonly associated with SEO events. Extant literature has documented significant changes in affiliated brokers' market share around various financial events in capital markets, such as SEOs, Initial Public Offerings (IPOs), Mergers and Acquisitions (M&As) and changes in analyst recommendations. For example, short selling activities around both the announcement and issuance dates of SEOs have been examined by Henry and Koski (2010), while Kim and Masulis (2011) observe order imbalance activities after SEOs in the U.S. market, attributing the trading pattern to market-making activities by underwriters. Since underwriters have a significant role in capital markets around SEOs, it is also interesting to investigate their affiliated brokers trading pattern around such offering events.[1]

The connections between the brokerage and research and advisory services by investment banks have been discussed by Ellis et al. (2000); Irvine (2001) and Niehaus and Zhang (2010). They generally find that investors who receive analyst research from the underwriting firms have an incentive to trade with their affiliated brokerage firms. Their findings suggest that a substantial

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[1] Affiliated broker is known as the analyst or broker from the same firm as an advisor or underwriter in a SEO.

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proportion of investors tend to trade with affiliated brokers after capital raisings. Ritter and Welch (2002) provide examples of quid pro quo commission arrangements for IPO allocation. They argue that IPO share allocations influence under-pricing, ownership structure, and underwriter compensation. Loughran and Ritter (2002) argue that investors tend to send trading commissions to the underwriter's brokerage in order to gain favourable IPO share allocation on hot deals. This finding is also supported by Goldstein et al. (2011), who also document the linkage between commission payments and hot IPO deals. Reuter (2006) studies mutual fund family's holdings and brokerage commissions in IPO deals and documents that lead underwriters tend to provide profitable IPO share allocations to investors with stable commission revenues. Goldstein et al. (2009) use Abel-Noser dataset and discover similar findings in other institutional investors. They suggest that institutional investors tend to obtain favourable share allocation by focusing on commission payments. Moreover, Nimalendran et al. (2007) suggest that underwriter's commission is one of the important determinants of IPO share allocation. Their empirical results revealed that abnormal trading volumes are most pronounced close to the IPO offer date, which may be indirect compensation for the underwriter's favourable allocation in IPO deals.

Similarly, in SEOs, we may also find interesting relationships between investors and underwriter's brokerage arm. Previous studies mainly focus on the trading patterns in the capital markets around SEOs, including order flow imbalance, analyst coverage and short-selling behaviour. Gerard and Nanda (1993) examine the secondary market trading patterns prior to SEO events, while Henry and Koski (2010) and Safieddine and Wilhelm (1996) study short-selling behaviour around SEO events. Lease et al. (1991) and Kim and Masulis (2011) examine order imbalance patterns around SEOs, while Corwin (2003) and Cotter et al. (2004) study trading activities, price stabilization and under-pricing of SEOs by analysing security characteristics of SEO events. However, studies on the trading activities of affiliated brokers in SEOs are very limited.

With a unique dataset of broker identification codes provided by the Australian Securities Exchange (ASX), we investigate the trading behaviour of brokers around SEO events in the Australian financial market. Moreover, we examine the abnormal patterns of trading volumes and market share for both affiliated brokers and unaffiliated brokers around SEOs. This study provide evidence that Australian broker trading activities are influenced by broker affiliation around SEO events, while examining the key determinants (such as stock characteristics, market movements, and broker characteristics) that affect affiliated and unaffiliated brokers' abnormal trading behaviour.

In this paper, we employ similar methodologies employed by Gerard and Nanda (1993) and Henry and Koski (2010) to examine the impact of SEO affiliation on the trading volume and market share of brokerage firms. We focus on changes in and the determinants of the trading volume and market share of both affiliated and unaffiliated brokers around two types of SEOs (private placements and rights offerings) in the Australian equity market between 2000 and 2009. The characteristics of these offering events are investigated to provide a better understanding of affiliated brokers' and unaffiliated brokers' trading volume and market share behaviour around SEOs. Further regression analysis offer insights into the key determinants that may impact on broker trading behaviour and market share around equity offering events. The findings should be of interest to advisory firms as well as affiliated brokerage firms in deal structuring, as SEO affiliation often lead to possible indirect compensation in the form of increased brokerage market share.

While SEO lead and co-managers may assist the company in pricing, marketing and determining the allocations of the shares, no trading by any broker takes place during the share issuance, which is a primary market function. Once the new securities come on to the secondary market, shareholders can trade through any broker, and do not necessarily have to become clients of the underwriters to trade those shares post issuance. The abnormal trading volume by affiliated brokers observed in this study may be a result of the underwriters:

1) providing liquidity, facilitation and market stabilising services using their house account around the time of the issuance;
2) accumulating inventory to conduct the aforementioned actions prior to the issuance;
3) trading on behalf of clients that have subscribed to the SEO in the secondary market after the company issued the shares to the clients in the primary market[2]; and
4) providing analyst coverage of the company around the SEO, which tends to stimulate trading interest in the security by its clients.

The inventory and liquidity offered by the SEO lead and co-managers may attract other brokers and their clients to interact with them on the secondary market.[3] While statistical inferences can be drawn about various determinants of broker trading volume and market share around SEOs, there is limited data to allow the examination of possible client migration across brokers or quantify the exact profitability impact of increase market share for underwriters. The elevated trading volume and market share of lead and co-managers around SEOs is likely a natural consequence of their affiliation and service provision, which would result in additional brokerage revenue in addition to underwriting revenue. This additional indirect compensation may be considered by investment banks when pricing SEO management and underwriting services. However, there is a rare possibility that the SEO manager may lose money trading shares for the purpose of liquidity provision, facilitation and market stabilization.

[2] This may be more relevant for private placements, where the institutional investor subscribing to the placement is typically also a client of the SEO broker.

[3] For example, if the client of another broker is seeking to acquire a large parcel of shares in the company that the underwriter has just managed an SEO for, the first broker may sound out the SEO broker to ask whether any parties that have been allotted the placement wished to offload their stake.