

# Why Don't Issuers Choose IPO Auctions? The Complexity of Indirect Mechanisms

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## Abstract

In this paper we present a comprehensive comparison of IPO placement methods in over 50 countries. We find that out of the three primary methods, fixed price public offers, auctions, and book building, auctions are least popular with issuers. Since auctions allow for price discovery while avoiding the potential conflict of interest between issuer and underwriter, this is a surprising finding that is not adequately explained in existing literature. We propose a new explanation: namely, that participating in auctions is substantially more difficult for investors compared to the other methods, and that this complexity can lead to investor behavior that is undesirable for the issuer. We suggest that this effect could be mitigated through a hybrid mechanism that resembles the one that is used in US treasury auctions.

*Keywords:* Initial Public Offerings, IPO, Auctions, Book building, Mechanism Design, IPO Auctions

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## 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 possibilities include book building, fixed price public offers, and auctions, as well as their various hybrids<sup>1</sup>.

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<sup>2</sup>.

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. Moreover, the auction method is old and well established, and has been particularly successful for US Treasury securities and other government debt instruments. Not surprisingly, it is often suggested that auctions are a superior method of IPO placement<sup>3</sup>. Nevertheless, to this day

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<sup>1</sup>We describe each method, and the primary differences between them, in more detail below in 2.1

<sup>2</sup>See Loughran and Ritter (2004) for discussion of the scandals and overall trends in IPO underwriting, and Ritter and Welch (2002), Ljungqvist (2007), Wilhelm (2005) for reviews of the academic IPO literature.

<sup>3</sup>Examples include "IPO Market Comes Back to Life", by Rachel Emma Silverman. Wall Street Journal, New York, N.Y.:Nov 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 U.S. issuers should be forced to use auctions (see for example, "The Value of Trust," Economist Staff, The Economist, June 07, 2002.) The U.S. 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.

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<sup>4</sup>. 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 the 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, more than 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, India and Israel, where there are (or until recently have been) restrictions preventing the use of book building.

In [Section 3](#) we argue that issuers’ preferences for price discovery are not sufficient to explain this apparent lack of popularity of auctions. We also present empirical evidence suggesting that it is not explained either by the lack of familiarity among investors, 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 to favor one method over the other based on fees. In spite of that, when issuers have been allowed to choose between fixed price public offers and auctions, the former method generally prevailed. The fixed price public offer method in turn lost market share when it faced competition from book building. Our findings refute the view that, but for the investment banks’ market power, standard auctions would have replaced the book building method for bringing new equity issues to the market.

Our explanation for the popularity of the book building method relies on the observation that each underwriter of an IPO has a network of *regular* investors. Because of the long-term enduring nature of the underwriter-regular investor relationship,<sup>5</sup> the underwriter is able to provide the necessary incentives to all investors participating in the book building process to truthfully reveal their views regarding what they think the issue is worth to them and how many shares they are willing to buy at various possible offering prices. Therefore book building can be thought of as being closer to a “direct” mechanism<sup>6</sup> that requires little sophistication on the part of participants. In contrast, bidding in IPO auctions requires a high degree of sophistication on the part of all the participating investors. In addition to valuing the shares being issued, each bidder must assess how many other bidders there will be, how much information they have, and what bidding strategies they will use, while at the same time accounting for the mistakes those other bidders may be potentially making – and all that makes bidding in an IPO auction a demanding task<sup>7</sup>. Much of the theoretical literature ignores how investors actually make decisions. In particular, they ignore the heterogeneity in investors’ levels of sophistication and ability to analyze IPO firms’ prospects, and hence their ability to participate in various mechanisms. When this heterogeneity is taken into account, it becomes apparent that auctions can be risky for both investors as well as issuing firms. We discuss these issues in [Section 4](#).

In [Section 5](#) we show how these issues played a role in the failure of some IPO auctions. We provide additional anecdotal evidence for the lack of popularity of IPO auctions, and investigate in greater detail IPO auctions in Singapore. We also discuss the differences between IPO auctions and auctions for Treasury bonds and why the latter

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<sup>4</sup>See also [Benveniste and Spindt \(1989\)](#) and [Benveniste and Wilhelm \(1990\)](#)

<sup>5</sup>See [Sherman \(2000\)](#) for a discussion of how long-term relationships with investors helps the underwriter to offer the issue at a higher price on average by favoring regular uninformed investors in allocations.

<sup>6</sup>Note that our use of the term “direct” is nonstandard

<sup>7</sup>Nonequilibrium bidding, and its effects such as persistent winner’s curse, has received high-profile attention in recent auctions research, e.g. [Eyster and Rabin \(2005\)](#) and [Crawford and Iriberry \(2007\)](#)

have been successful. We believe that the evidence we present makes the lack of popularity of IPO auctions less of a puzzle. We conclude in Section 6.

## 2. Global Patterns and the Surprising Rarity of IPO Auctions

When Margaret Thatcher, Prime Minister of the UK, began privatizing British companies, she set off major changes around the world in government, in industries and in IPO methods. Before then, the IPO method in most countries outside the US was fixed price public offer (a.k.a. open offer, universal offer or often simply called “the IPO method”). The trend towards floating extremely large public companies forced countries to try new methods and to coordinate IPOs across borders, since many privatizations were too big to be absorbed entirely by the local market. The wave of privatizations led to experimentation first with auctions and then with the US book building method.

Before we proceed with our investigation of international IPO experience, we will first describe the existing methods and their defining features.

### 2.1. IPO Mechanisms: Fixed Price Public Offers, Book Building, and Auctions

In *fixed price public offers*, the price and allocation rules are set before information on demand is received, and shares are allocated according to the rules announced earlier.

With *book building*, the underwriter typically arranges for investors to attend a road show and then collects indications of interest, which are used to build the order book. The offering price is set only after the order book is full, giving the underwriter some idea of demand. The underwriter has substantial discretion over allocations, with those customers who helped in pricing the issue and those with long term relationships with the underwriter tending to get more favorable treatment.

*Auctions* for IPOs have taken several forms. Uniform price auctions are multi-unit sealed bid auctions in which all winning bidders pay the same price. The price paid may be the market-clearing price (the highest price that allows all shares to be sold), or it may be below the clearing price, leading to increased rationing. A “dirty” IPO auction is a uniform price auction where they “leave something on the table” by pricing below market-clearing. In a discriminatory or pay-what-you-bid auction, each winning bidder pays his or her own bid. While some auctions restrict entry, historically most IPO auctions have been of an open public nature. The auction price is based on investor bids, but unlike book building, auction allocations are usually determined by rules that are set, and publicly announced, prior to bidding, thus eliminating underwriter discretion with respect to allocations.

With either fixed price public offers or sealed bid auctions, underwriters may, and sometimes do, hold road shows before the offer price is set. As in book building, they are allowed to ask for feedback that may influence the offering price in the case of the fixed price public offer or the reservation price in the case of auctions. However, without control over allocations, underwriters may not be able to offer enough of an incentive for investors to produce and share information.

Many countries have used hybrids – combinations of any two of the three methods. There have been hybrid auction/public offer and auction/book building IPOs, but the most common combination is book building/public offer. For most hybrids, book building (or sometimes an auction) is used to set the price and to allocate shares to institutional and foreign investors, while a fixed price public offer tranche is reserved for local retail investors that do not participate in the price-setting process<sup>8</sup>. For example, hybrid book building/auctions on the exchange are used in Chile because of regulations, but the offer price is set through book building<sup>9</sup>.

As mentioned earlier, we will refer to commonly used uniform-price and discriminatory auctions as *indirect* mechanisms, where every participant will have to factor in what other participants know and how they will bid before

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<sup>8</sup>There are two types of hybrids: simultaneous and sequential. With sequential hybrids, the price-setting tranche is completed first, so that the price from that tranche can be used for the subsequent fixed price public offer. Simultaneous hybrids are often called ‘open pricing’, since investors have to place orders while the offer price is still ‘open’ (before the final price is set). This allows both tranches to run at the same time, thus allowing the offer price to be set as late as possible.

<sup>9</sup>Pension funds may only purchase shares through an exchange in Chile, so some IPO shares are sold on the floor of the exchange, after the offering price has been set and the rest of the shares have been allocated through book building. Such auctions may occur only minutes before general trading on the same floor. In its 2003 IPO, La Polar canceled the auction completely and distributed its shares through a book build and through brokerages.

submitting their own bids. In contrast, in *direct* mechanisms the incentives are such that all bidders report their valuations truthfully to the auctioneer (underwriter). Book building may come closer to a direct mechanism, with bidders privately communicating their valuations to the underwriter, and the underwriter setting prices and allocations in a way that provides them with sufficient incentives to report.

It is well known that for a large set of mechanisms, the Revelation Principle (Myerson, 1981) states that for any indirect mechanism, there exists a direct one that generates identical outcomes in model economies. However, outcomes of theoretically equivalent direct and indirect mechanisms often differ in laboratory experiments<sup>10</sup>. Whether this is an important enough issue in the case of IPOs can only be discerned based on the historical experience of countries that have experimented with several different mechanisms for IPOs.

## 2.2. International Historical Evidence

We conduct an extensive study of IPO placement practices in 50 countries. Unfortunately there is no standard reliable source of international data on IPO placement methods<sup>11</sup>. Table 1 summarizes the IPO methods used in each country, with more detailed information given in Table C.1. As one can see in these tables, most countries allow the use of many methods. We do not know of any country that had formerly allowed auctions and then changed their regulations to prohibit or limit them, or of any country that has forced issuers to use book building – the general trend in the last two decades has been to allow greater choice among issuers.

There are two notable patterns. First, the book building method was once rare outside the US but is now common. Second, auctions have been tried in more than 25 countries but are rare today.

Table 1 shows that the traditional method (in other words, the first and for many years the only method) in most countries is fixed price public offer. It also shows that nearly all countries except the United States are still using fixed price public offer in some form, either alone or as part of a book building hybrid. As a rough generalization, Table 1 shows that experimentation with auctions began in the 1980s or earlier in Europe, and in the 1990s or later in Asia and the Americas, but the auction method generally was dropped within a few years. Experimentation with book building exploded in the mid-1990s, and the method seems to have ‘stuck’ in most countries, again as a hybrid with fixed price public offer. Auctions usually were abandoned before book building was introduced, so that there have only been a few countries in which both methods were in use at the same time.

Although auctions have been used in more than half of the 50 countries listed in Table 1, the method seems to have been entirely abandoned in all but three or four of them, and usage is rare even in those few remaining countries. As can be seen in Table C.1, auctions are used sporadically in the US, at a rate of less than 2 per year (22 from 1999 to mid-2012). They are the only method allowed in Vietnam, and a restricted type of auction is used in India, which prohibits book building. They have been frequently used in the past in Israel, where auctions were the only allowed method for a decade. Book building has been allowed in Israel since mid-2007, but the market has not been active since that regulatory change, so it is too early to tell how the choice of issue methods will evolve there.

In India, book building was first allowed in the 1990s but was not popular for many years. Eventually, after regulatory changes, book building became more popular there, but in 2005 the Indian regulator<sup>12</sup> began mandating pro-rata allocation among bidders, thus effectively banning book building. In Indian IPOs, the issue manager sets a price band for the issue, and investors have to submit bids with prices falling within that price band. Interestingly, in 76% of the 309 Indian IPOs during the period January 2000 to December 2010 that used the book building method, the offer prices were set at the maximum of the price range. In 13% of the IPOs the offer prices were at the floor, and the rest had the offer prices at the mid point. Indian IPOs therefore resemble a dirty version of a fixed price public offer rather than book building or a uniform price auction.<sup>13</sup>

Auctions are being used in Vietnam, but issuers there are allowed no choice of methods. Vietnam is still developing its markets in its transition away from central planning, and most IPOs are privatizations.

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<sup>10</sup>See e.g. Charness and Levin (2005).

<sup>11</sup>SDC Platinum offers the currently most extensive international IPO database. It includes indicators of placement and pricing techniques, but unfortunately these are missing for a large part of the dataset, and worse, are rather unreliable in terms of describing the actual process: e.g. auctions in Taiwan, Singapore and France are inconsistently classified as either fixed price or book building; on the other hand, many book built issues in US and UK are classified as fixed price, etc.

<sup>12</sup>see SEBI Circular #SEBI/CFD/DIL/DIP/16/2005/19/9

<sup>13</sup>Private communication from Amit Bubna

**Table 1: Summary of IPO Methods Used in Various Countries.**

A blank in any column means that, to the best of our knowledge, the method was not used. The “first introduced” years are the earliest years that we were able to find but may be later than the actual year of first use. On whether the book building method is now dominant or gaining in popularity, the answer is in the judgment of the main source listed in Table C1, or our best estimate if no other source was available. News article sources for any country are available upon request.

	Traditional method(s)	Auctions		Book Building		
		First introduced	Apparently abandoned	First introduced	Now dominant or gaining?	Hybrid with Fixed Price
<b>Europe</b>						
Czech Republic	Fixed price			2004	yes	yes
Finland	Fixed price			1993	yes	yes
France	Auctions, fixed price	1964	1999*	1993	yes	yes
Germany	Fixed price	1999		1995	yes	yes
Greece	Fixed price			1994	yes	yes
Hungary	Fixed price			1995	yes	yes
Ireland	Fixed price			1992	yes	yes
Italy	Fixed price	1980s	1986	1992	yes	yes
Netherlands	Fixed price	1980s	1989	1994	yes	yes
Norway	Fixed price			1995	yes	yes
Poland	Fixed price	1994	1995	1995	yes	yes
Portugal	Fixed price	1987	1992*	1995	yes	yes
Spain	Fixed price	1988		1993	yes	yes
Sweden	Fixed price	1980s	1980s	1994	yes	yes
Switzerland	Fixed price	Mid-1980s	1987	1995	yes	yes
United Kingdom	Fixed price	1960	1986	1992	yes	yes
<b>N. &amp; S. America</b>						
Argentina	Fixed price	1991	1992	1993	yes	yes
Barbados	Fixed price			Never		
Brazil	Fixed price	Late 1980s	1994	1992	yes	yes
Canada	Book building			Early	yes	yes
Mexico	Fixed price			None yet		yes
Paraguay	Fixed price			Never		
Peru	Fixed price			1996	yes	yes
United States	Book building	1999	Still using	Early	yes	no
<b>Asia/Pacific</b>						
Australia	Fixed price	1999	1999	1993	yes	yes
Bangladesh	Fixed price	Allowed, 2009		Never		
China	Fixed price	1999	2002	2005*	yes	yes
Hong Kong	Fixed price			1994	yes	yes
India	Fixed price	2005*	Still using	1999	Banned, 2005	yes
Indonesia	Fixed price			2000	yes	yes
Japan	Fixed price	1989	1997	1997	yes	yes
Korea	Fixed price	1993		1997	yes	yes
Malaysia	Fixed price	1992	1994	2002	yes	yes
New Zealand	Fixed price			1997	yes	yes
Philippines	Fixed price	1994	1994	1998	yes	yes
Singapore	Fixed price	1991	1994	1999	yes	yes
Sri Lanka	Fixed price			Never		
Taiwan	Fixed price	1995	2003	2004	yes	yes
Thailand	Fixed price			1994	yes	yes
Vietnam	Auctions	2005	Still using	Never		
<b>Africa/Middle East</b>						
Egypt	Fixed price			2000		yes
Kenya	Fixed price			2008		yes
Israel	Auctions, fixed price	By 1980	?*	2008		
Jordan	Fixed price	5		Never		
Pakistan	Fixed price			Never		
South Africa	Fixed price			1994		yes
Turkey	Fixed price	1994	1995*	1997		yes

\*Some unusual features or exceptions. See Table C.1 for more detail.

In France, auctions were popular in the first half of the 1990s. On the regulated exchanges, they gradually lost market share to sequential hybrid book building over several years, then dried up quickly in 1999 when simultaneous hybrid book building was allowed. Auctions continued to be used on the unregulated over-the-counter market (the *Marche Libre* or Free Market) for several more years, although they eventually seem to have dried up there, also. There were, however, two IPO auctions in France in early 2005<sup>14</sup>, which came after there had been no auctions on regulated French exchanges for half a decade.

Auctions were the only method allowed in Israel for a decade. The law requiring their use expired in December, 2003, after which issuers were allowed to effectively choose a fixed price public offer by setting a maximum price for the auction. Many of the IPOs between 2004 and mid-2007 chose to set a relatively low maximum price for their offerings, thus effectively choosing fixed price over auction<sup>15</sup>. In July 2007, a long-debated change went into effect, allowing book building for the first time. It is too soon at this point to tell how auctions will compete with book building in the Israeli market.

In Latin America, auctions have been used in Argentina, Brazil and Peru in the past. Latin American markets were quiet for many years, with delistings outnumbering listings in Brazil, Argentina and Chile<sup>16</sup>. Thus it was hard to predict if auctions were gone completely. However, Brazilian, Chilean and later Argentinean IPO markets began picking up in 2004-2005, with even stronger activity in 2006, and book building has been the dominant method, with no auctions that we know of.

Since 1995, Taiwan has allowed both auctions and book building, in addition to the traditional fixed price public offers. Taiwan's auctions are similar to those that were once required, and are still allowed, in Japan – sequential hybrids in which discriminatory (pay-what-you-bid) auctions are followed by fixed price public offers. Auctions were initially popular but lost market share over time, with more and more issuers returning to pure fixed price public offers. Book building was originally allowed only in certain restrictive circumstances but has gained popularity in the last few years.

In the US, the investment bank WR Hambrecht has been encouraging issuers to use auctions since mid-1999. The method got much publicity when Google, a popular search engine company, chose to use the auction method for its August, 2004 IPO, but still the auction method is not popular in the US. As of 2011, there have been 22 US IPO auctions, 19 of them lead-underwritten by WR Hambrecht through its OpenIPO method. Of the other 3 US IPO auctions, the lead underwriters were: Credit Suisse and Morgan Stanley for Google in 2004; Credit Suisse for Netsuite in 2007; and Credit Suisse, Goldman Sachs and Merrill Lynch for Rackspace in 2008. US auctions have had some unusual features (see the “United States” column of Table C.1, p.40).

Several types of IPO auctions have been used. Brazil, Japan, Malaysia, the Philippines, Singapore, Taiwan and the UK have used discriminatory auctions, while Argentina, Australia, Brazil, Finland, France, India, Israel, Malaysia, the Netherlands, New Zealand, Norway, Peru, Portugal, Singapore, Turkey, the UK, the US and Vietnam have used uniform price auctions. Dirty (priced below market clearing) auctions have been used in Australia, Belgium, Finland, France, Hungary, India, Malaysia, New Zealand, Singapore, Turkey, the UK, and the US.

Thus out of 50 countries, auctions have been tried in at least half, and yet all except India, Israel, Vietnam and the US seem to have abandoned them entirely, and even in these last few countries, either auctions are rare or choice among IPO methods is restricted. Book building is gaining in popularity or is already the dominant method in more than 40 of the countries. Fixed price public offer is still used in smaller countries and for smaller offerings, and is used for the retail tranche of hybrids, which are standard.

If, as we conjecture, the reason for book building's dominance is that it is a “direct” mechanism, then the popularity of fixed price public offers in less active markets is to be expected. As we shall see below, implementing a mechanism such as book building requires an established, trusted and sophisticated underwriter, communicating with investors who have sufficient capacity to collect and process information. Lacking these conditions, the potential benefits of

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<sup>14</sup>The two 2005 auctions were for Cafom, on the Second Marche in January and for MG International, on Alternext in June. There have been no further auctions in France as of mid-2012.

<sup>15</sup>The law for one decade had forbidden the use of a maximum price. Technically, Israel was using auctions even before this, but it had become standard to set the maximum price so low that it was virtually sure to be hit, thus effectively making the method a fixed price method. In 2007, Itamar Medical, Maayan Ventures, Clal Finance and Brainsway all set maximum prices for their IPOs, and all ended up being priced at those maximums, but we have not yet been able to verify what proportion of all TASE IPOs set maximum prices.

<sup>16</sup>For example, Chile had no IPOs at all from 1998 to 2001 and only one each in the years 2002 and 2003.



book building disappear and simple fixed price public offers become more attractive due to their simplicity: they rely much less on the reputation of the underwriter compared to book building, and require much less sophistication on the part of investors compared to auctions. Hybrids can be fine-tuned to specific requirements and are therefore observed in a wide range of markets.

### 3. Rarity of IPO Auctions: Popular Explanations

In what follows we discuss several commonly offered explanations for the lack of popularity of IPO auctions, and argue that they are not fully consistent with observed global evidence.

#### 3.1. Heterogeneity in issuing firms' objectives

One of the explanations advanced in the literature for the popularity of the book building method is the flexibility it offers the issuing firm relative to auctions when it comes to the tradeoff between minimizing underpricing and promoting information gathering by investors. Indeed, there are several reasons to believe that issuers care about other aspects of the process beyond just the magnitude of underpricing as evidenced by initial returns. For example, one reason to go public is to give current stockholders such as the founders, venture capitalists and angel investors a chance to diversify by liquidating at least part of their holdings. Such investors usually cannot sell until the end of the lock up period and thus care about the eventual stock price as well as the offer price and first day's trading price. If a deep, liquid market is not established, those investors may be unable to sell their shares at a reasonable price, even after the time and expense of an IPO. Companies that go public but do not attract an institutional investor following may not be sufficiently covered by analysts, or monitored closely enough to be accurately priced. This means that they will be unable to do follow-on equity offerings and will tend to trade at a substantial discount, due to their illiquidity and added risk. In order to minimize this possibility, firms may be willing to pay, through underpricing, to attract the attention of serious investors in the IPO<sup>17</sup>. This may explain the importance of analyst coverage found in [Loughran and Ritter \(2004\)](#), [Cliff and Denis \(2004\)](#) and [Mola et al. \(2010\)](#). In the words of Martin Manley, Chairman and CEO of Alibris<sup>18</sup>, "Taking a company public is like getting a heart transplant: you only do it once and you need it to be done very, very well. It is not a decision driven by price."

This brings up the question of what objective function issuers are maximizing when choosing an IPO method. [Loughran and Ritter \(2004\)](#); [Sherman and Titman \(2002\)](#); [Sherman \(2005\)](#), and [Chemmanur and Liu \(2003\)](#) offer alternative objective functions that consider more than just maximizing proceeds. The appropriate objective function for IPO issuers is a subject in itself, and one worthy of future research. In this paper, we simply note that the evidence indicates that issuers care about more than just maximizing the expected proceeds from the IPO.

[Sherman \(2005\)](#) compares open uniform-price and discriminatory auctions to the results of a mechanism-design approach in which the underwriter invites investors to participate and has discretion over both pricing and allocations. This optimal mechanism is termed "book building", because book building, from a regulatory standpoint, allows the issuer to choose price and allocations.

She considers the possibility that an issuer's utility may depend on both expected proceeds and pricing accuracy<sup>19</sup>, and shows that the ability to control allocations offers additional flexibility, allowing the underwriter to decide on the tradeoff between the two objectives. However, as [Sherman \(2005\)](#) demonstrates, auction outcomes can sometimes be close to those of the optimal mechanism, as we can see from her example in which issuers who place a high value on pricing accuracy can do well with a discriminatory auction<sup>20</sup>. The key disadvantage of the sealed bid auctions that Sherman models is largely due to the "open public" (i.e. every investor has the option to participate) setting,

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<sup>17</sup>Underpricing as a way of inducing costly evaluation has been modeled in [Sherman \(1992\)](#), [Chemmanur \(1993\)](#), [Booth and Chua \(1996\)](#), [Sherman \(2000\)](#), [Sherman and Titman \(2002\)](#) and [Busaba and Chang \(2003\)](#). [Yung \(2005\)](#) models costly evaluation by both investors and the underwriter. [Cornelli and Goldreich \(2001\)](#), [Jenkinson and Jones \(2004\)](#) and [Cornelli and Goldreich \(2003\)](#) offer evidence on whether or not book building performs this role in practice. See [Sherman and Titman \(2002\)](#) for a list of additional reasons why issuers may prefer more accurate pricing.

<sup>18</sup>Alibris held an IPO auction through WR Hambrecht in May, 2004, but canceled it after observing the bids. See Mr. Manley's blog, Jam Side Down, at [http://www.martinmanley.com/ipo\\_diaries/](http://www.martinmanley.com/ipo_diaries/).

<sup>19</sup>Defined in the paper as the probability that at least one investor receives an informative signal.

<sup>20</sup>See [Sherman \(2005\)](#), Table 1, p.633.

rather than of the auction method itself. A private (“by invitation only”) auction would not have this disadvantage. Moreover, the comparison in [Sherman \(2005\)](#) does not account for the lack of transparency and resulting potential for abuse that occurs with book building, because of the agency problem between the issuer and underwriter. Thus, at least under certain conditions, auctions may have an advantage over book building because of their transparency. Hence, it would be difficult to explain the extent to which book building has come to be the dominant IPO mechanism in practice based only on the reasons that have been advanced in the theoretical finance literature.

### 3.2. *Unwillingness to try a new method?*

Another possible explanation for the low numbers of IPO auctions in the US is that the auction method is simply too new and experimental, and that issuers are afraid to try an unproven method. This is plausible, since an IPO is a very expensive, very public step for a company, so issuers may not be anxious to experiment. However, this ‘lack of familiarity’ argument cannot explain the overall low market share of the auction method around the world. First, the mere fact that IPO auctions have been used in at least half the countries for which we have information implies that quite a few issuers have been willing to experiment. More importantly, if we look at relative usage patterns over time, issuers have been most enthusiastic about IPO auctions when the method was new, and they generally became less willing to use it after they had become more familiar with the method.

Figure 1 shows the relative auction usage patterns over time in four countries. For Singapore, Taiwan and Turkey, the main alternative method was fixed price public offers, which had been the traditional method in those countries. Auctions were first allowed in 1993 in Singapore<sup>21</sup> and Turkey, and in 1995 in Taiwan. In France, both auctions and fixed price public offers had been used for decades, but sequential hybrid book building was first introduced in the 1990s, while standard book building was only allowed beginning in 1999.

As can be seen from Figure 1 for the three countries in which the open IPO auction method was newly introduced, auctions captured their greatest market share early on, with two-thirds or more of issuers choosing to use auctions when they were relatively new. As issuers became more familiar with the method over time, a lower proportion of them chose to use the auction method. Hence, it is hard to argue that, in these countries, the disappearance of IPO auctions was due to lack of familiarity or to an unwillingness of issuers to try a new method.

Of the four countries whose usage patterns are shown in Figure 1, France differs from the others in several ways. First, the auction method had been allowed for several decades in France. Second, a form of book building was in use during the period shown, in addition to auctions and fixed price. Last, the disappearance of auctions from the regulated exchanges seems to have been driven by a regulatory shift that allowed greater choice.

[Derrien and Womack \(2003\)](#) found that sequential hybrid book building was less efficient than auctions in France due to the requirement that the price be set too far in advance. Before 1999, the only form of hybrid book building that was allowed in France was a sequential hybrid, where the price must be set in advance to allow time for the public to place their orders. As the modeling in [Chowdhry and Sherman \(1996a\)](#) demonstrates, setting prices too early adds risk, leading to higher levels of underpricing. Once the more modern, simultaneous hybrid book building method was allowed in France in 1999, auctions quickly vanished from the regulated exchanges<sup>22</sup>. The 1999 regulatory change seems to explain the timing of auctions drying up on the French regulated exchanges, although it does not explain why they were still used for several more years on the unregulated over-the-counter Free Market (*Marche Libré*). Eventually, as shown in Figure 1 (Panel E), auctions also dried up on the Free Market.

One obvious question is whether issuers in these countries were truly allowed to choose freely between IPO methods. Although there were no regulatory restrictions that prevented issuers from using auctions, strong differences between the groups of issuers using different methods might imply some other sort of barrier, such as underwriter reluctance to underwrite auctions for some issuers. Therefore, in unreported analysis, we compare fixed price public offers and auctions in Singapore, Turkey and on the French Free Market based on both industry and amount of funds raised<sup>23</sup>. We did not find substantial differences in the size or industry patterns of auction and non-auction issues.

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<sup>21</sup>The graph shows only uniform price auctions for Singapore. Singapore also had one discriminatory auction in 1991 and one in 1992. Uniform price auctions were first allowed in 1993.

<sup>22</sup>With the exception of the two IPO auctions in 2005 that were mentioned in Section I.

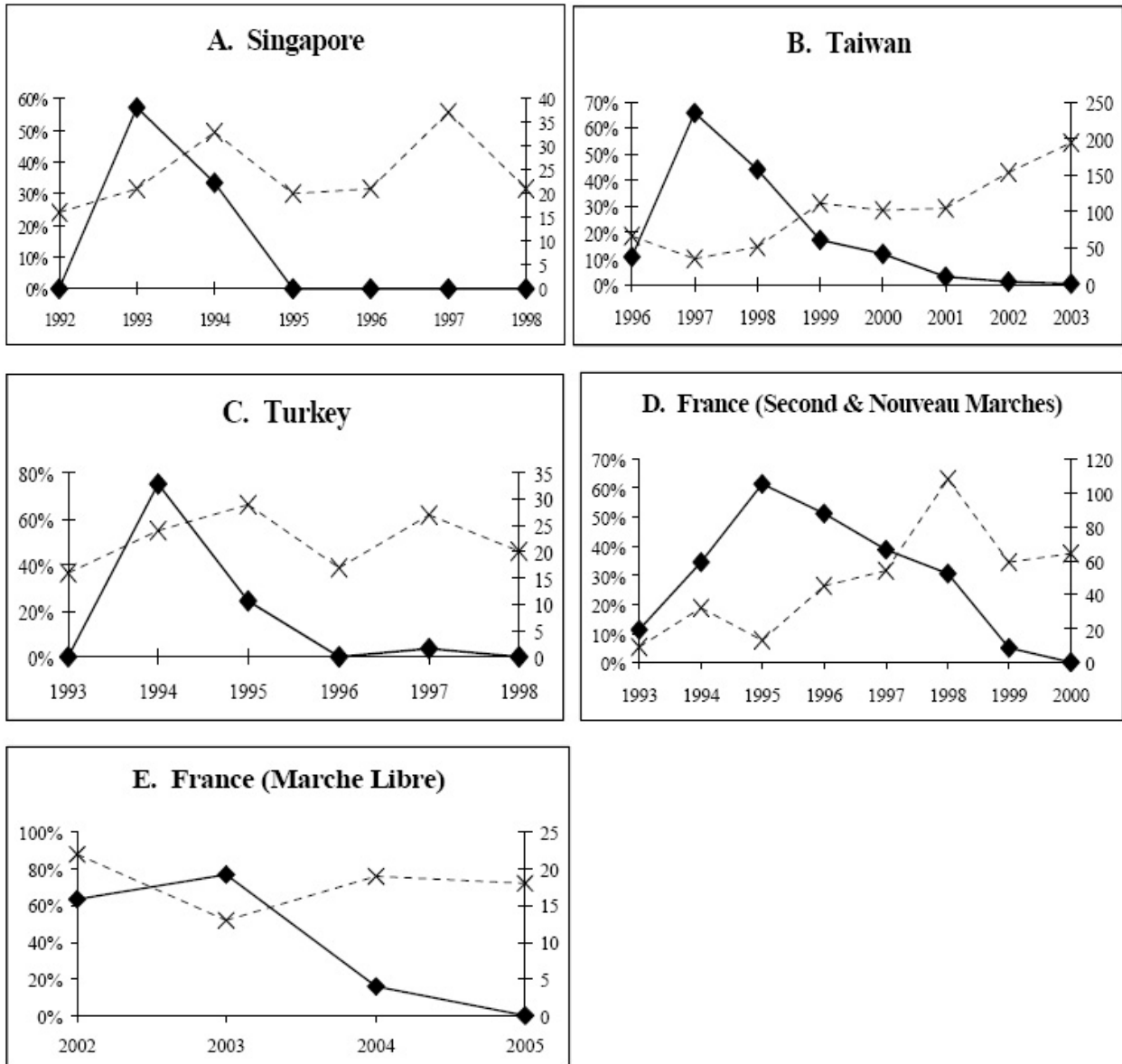
<sup>23</sup>Comparisons of French Second and Nouveau offerings can be found in [Derrien and Womack \(2003\)](#) and [Degeorge, Derrien and Womack \(2007\)](#). [Hsu and Hung \(2005\)](#) compare Taiwan IPOs by method.



**Figure 1: How Auctions Evolved over Time in Four Countries**

In each graph, the X's (right axis; connected by dashed lines) give the number of total IPOs per year in that country, while the diamonds (left axis; connected by solid lines) are the percentages of IPO auctions out of all IPOs.

Sources: A: E-mail from the Stock Exchange of Singapore, October, 1999. B: The data was given to us by K.C. John Wei. See [Liu et al. \(2001\)](#) and, for 2002-2003 data, [Hsu and Hung \(2005\)](#). C: E-mail from the Istanbul Stock Exchange, March, 1999. D: [Derrien and Womack \(2003\)](#) and [Chahine \(2001\)](#). E: Euronext website ([www.Euronext.com](http://www.Euronext.com), in IPO Archives).



Thus it is clear, in all four of the countries shown in Figure 1, that the disappearance of auctions was not due to issuers' lack of familiarity with the auction method. Similarly in Japan, issuers were forced to use auctions from 1989 to 1997. In spite of the long period during which IPOs in Japan were accomplished exclusively through auctions, the method was abandoned as soon as issuers were given the option of instead using book building.

There is not enough evidence to conclusively reject the 'lack of familiarity' argument for all countries. It may explain why auctions have not caught on in countries with limited usage, such as Germany, Australia or the US, or in countries that have never tried auctions at all. It may also explain why open public auctions for corporate debt and seasoned equity never caught on<sup>24</sup>, even though there was a race between three investment banks to introduce online corporate bond auction platforms in 2000<sup>25</sup>, and WR Hambrecht offers an online seasoned equity auction method known as OpenFollowOn<sup>26</sup>. But the overall IPO evidence is that issuers in many countries have been willing to experiment with both auctions and book building, and that issuers became less likely to choose auctions as they gained familiarity with the method.

### 3.3. Underwriter Pressure for Using the Book building Method

Another explanation, suggested by Ausubel (2002), for the failure of issuers to use IPO auctions is that investment banks have sufficient market power to negotiate the use of book building rather than auctions because the fees, and hence profits, are higher for book building. This argument is somewhat incomplete. While market power can explain the high fees, it can not by itself explain the choice of the issuing method: if underwriters have sufficient market power to keep book building fees artificially high, and sufficient market power to influence the offering method chosen by the issuers, they would presumably also have sufficient market power to negotiate high fees for auctions<sup>27</sup>. In fact, auctions have usually been replaced by fixed price public offers, and public offer fees are typically as low as, or even lower than, the fees for auctions. Underwriters with market power would have preferred auctions if fees were the only consideration.<sup>28</sup>

Another version of the market power argument takes into account hidden soft benefits from using the discretion over allocation: Underwriters may have an incentive to pressure issuers to use methods that lead to higher initial returns, so that the underwriters can allocate the underpriced shares to their favored clients. However, that cannot explain the choice between auctions and fixed price public offers, since neither method allows the underwriter to control allocations, and as mentioned earlier auctions were associated with higher fees<sup>29</sup>.

## 4. Why Do Issuers Avoid Auctions?

In this section, we argue in favor of a different reason for the apparent lack of popularity of IPO auctions. In particular, most auction models abstract away from the actual decision-making process of the agents, assuming instead

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<sup>24</sup>Bortolotti et al. (2006) show that auctions, in the form of block trades, have increased dramatically in the last decade and have become quite common around the world for seasoned equity offerings. The success of these SEO auctions fits well with our findings for IPOs, since the block trade auctions are single-unit auctions among a small group of sophisticated buyers – investment banks. The investment bank that wins the auction buys all of the shares at the winning bid price and then resells them on the market. With only one buyer, there is no room for free riders. Because the shares are relatively easy to value (since they are already trading) and the number of potential bidders is relatively small, these auctions are closer to Treasury bill auctions than to the types of auctions that have been used for IPOs.

<sup>25</sup>On August 10 2000, Deutsche Bank and Bear Stearns each auctioned off their own debt on their newly-developed platforms, while WR Hambrecht held its first OpenBook debt auction, for Dow, on August 15, 2000. WR Hambrecht handled a second OpenBook auction, for Ford Motor Credit, in March, 2001. It reportedly also attempted an auction for Dayton Hudson, but the bid-taking system crashed during the auction.

<sup>26</sup>Overstock, a company that also went public through an OpenIPO, used the OpenFollowon method in May of 2004 but chose a traditional marketed offering for its next follow-on in November, 2004.

<sup>27</sup>A related argument is given by Degeorge et al. (2007), who show a correlation in France between greater publicity/analyst attention for IPOs and the use of book building rather than an auction (they do not analyze the fixed price public offers in their sample). They argue that underwriters induced issuers to use book building by convincing them of the value of other services (more analyst attention). However, the question why such services would be bundled only with book building, rather than with all three methods in use at the time remains a puzzle.

<sup>28</sup>Ljungqvist et al. (2003) show that average fees tend to be quite low for fixed price public offers across most countries, substantially below those for book building. Chahine (2001), examining French data from 1996 to 2000, found that the mean, median and standard deviation of gross spreads were slightly lower for fixed price than for auctions. In most countries, when auctions were first used, the fees were the same for auctions as for fixed price public offers.

<sup>29</sup>Many countries allow orders in fixed price public offers to be favored on the basis of order size, but this usually involves favoring small over large orders. Chowdhry and Sherman (1996b) show that favoring small orders may reduce the Rock (1986) winner's curse. Parlour and Rajan (2005) also examine rationing in IPOs.

that, whatever the process is, it is consistent with the game-theoretical equilibrium. However, this assumption is often in disagreement with evidence, as indicated by the existence of the winner’s curse in many experimental and real-world situations. In order to reconcile this evidence with theory, a number of alternative equilibrium specifications have been proposed, such as level- $k$  bidding (Crawford and Iriberry, 2007), “cursed equilibrium” (Eyster and Rabin, 2005), or quantal response equilibrium (McKelvey and Palfrey, 1995). The common feature of these methods is that they allow agents to deviate from traditional expected utility maximization under Bayesian beliefs and allow for some form of bounded rationality. Allowing for such alternative behavior by agents may be relevant when modeling investors who participate in IPOs given the difficulties involved in valuing IPOs even for sophisticated investors.

Sherman (2005) has shown that sealed bid auctions are subject to participation swings, and thus to uncertainty over outcomes, even in an equilibrium with rational, informed bidders. As we discuss below, bounded rationality, when combined with fixed costs of participation and dynamic updating of beliefs, can generate even larger swings in participation. We argue that such swings can deter rational sophisticated investors from participating, and lead to an increased probability of either low proceeds or even an outright placement failure for the issuer.<sup>30</sup>

To make our discussion more specific, consider a “baseline” auction model based on Milgrom (1981) (fully described in Appendix A). Notably, its equilibrium is characterized by fairly low discounts (compared to those often observed in real-life IPOs) even with a modest number of participants (Figure 5), and in presence of risk aversion (Figure 3) and noisy signals (Figure 4).

To see what may be going wrong with auctions in practice, it is important to note two somewhat related issues: (i) the prevalence of the winner’s curse in many real-life auctions, and (ii) the relationship between the number of participants and the discount, particularly in a setting when the number of participants can be stochastic.

In what follows, we provide a brief review of the properties of uniform price auctions before illustrating the high level of sophistication that is required to avoid the “winner’s curse” while bidding in auctions.

Figure 2 shows equilibrium bidding functions (showing an equilibrium bid as a function of an investor’s signal), depending on the number of participants in an auction. Note that when  $N = 2K$ , so that the number of winners is equal to the number of losers, bids are very close to the signals, i.e., little correction for the winner’s curse is necessary. However, as the number of participants grows, so does the strength of the negative signal associated with winning the auction: it now implies that the original bidders’ signal likely was in the right tail of the distribution and was overstating the underlying share value (“Winner’s Curse”). Consequently, bidders shave their bids. On the other hand, when  $N < 2K$  so that there are more winners than losers, *losing* the auction is an indication of the signal biased downwards (“Loser’s Curse”), and bidders adjust their bids upwards instead.

Note that if bidders underestimate the number of bidders or under-react to an increase in the number of bidders, they would insufficiently shave their bids, resulting in overbidding. Below we argue that this type of an under-reaction is a likely explanation for the large fluctuations in participation, followed by abandonment of auctions by issuing firms in several countries.

#### 4.1. Behavioral Biases in Expectation Formation

As we saw above, the required bid-shaving to avoid the winner’s curse depends on the number of other participants in the auction. When there is uncertainty about the number of other bidders, coming up with the correct bidding strategy can be difficult and even sophisticated investors may find it difficult to avoid the winner’s curse<sup>31</sup> In what follows we illustrate the difficulties associated with bidding in an auction with an example somewhat resembling a popular TV game “Let’s Make a Deal”<sup>32</sup>:

Consider an auction similar to the one analyzed in the previous section, where  $K = 15$  lots of shares are auctioned, and the number of participants,  $N$ , will be 20 or 150 with equal probability, and each bidder is allowed to bid only for one lot. For expositional convenience assume that all the bidders follow the strategy such that, conditional on winning

<sup>30</sup>In Jagannathan et al. (2010) we show that an optimal truth-telling IPO auction mechanism would be characterized by many features that are commonly associated with book building, which simplifies the agents’ problem by transferring the “computational burden” to the underwriter, who has immediate interest in making sure that the process stays attractive for both issuers and investors.

<sup>31</sup>While it may be difficult to fix the uncertainty about the number of bidders in an auction, it will be difficult to address the uncertainty associated with how much those other bidders know and how they will bid.

<sup>32</sup>[http://en.wikipedia.org/wiki/Let's\\_Make\\_a\\_Deal](http://en.wikipedia.org/wiki/Let's_Make_a_Deal)

## Simulated Uniform-Price Auctions.

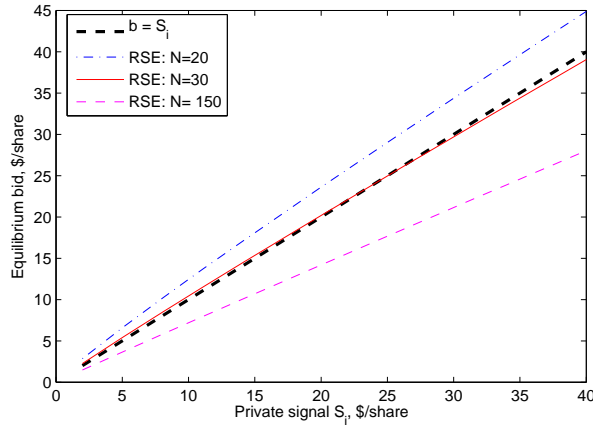
Allocations and discounts in simulated uniform-price unit-demand auctions. Unless otherwise specified, the log of the value of a share and the log of each signal about the value of the share are jointly normally distributed with  $\sigma_V = \sigma_S = 0.3$  and  $EV = ES = 10$ . There are  $N$  participants, each bidding for at most one lot of 100,000 shares, with the total of  $K = 15$  lots offered. Except in Figure 3, all bidders are risk-neutral.

Even with zero information, transaction and opportunity costs, an open auction does not completely eliminate underpricing. It occurs due to the finite number of participants, and becomes larger when bidders are risk-averse. The auction discount, depending on the number of participants and their degree of risk aversion, is shown in Figure 3. Note that, in this example, even when the number of participants is relatively small, the auction discount is low when bidders are risk neutral (between 1% and 2% in the twice-subscribed case of  $N = 30$ ). The discount can go up substantially when bidders are sufficiently risk averse and ill diversified.

Aggregate uncertainty, which enters this model due to imperfect revelation of the true underlying value through a limited number of noisy signals, increases the expected discounts, as one can see from Figure 4. For example, when the standard deviation of the signal doubles, the underpricing in the twice-oversubscribed auction also doubles. As the number of participants grows, price discovery improves, and both mean expected discount and their variance are reduced (Figure 5).

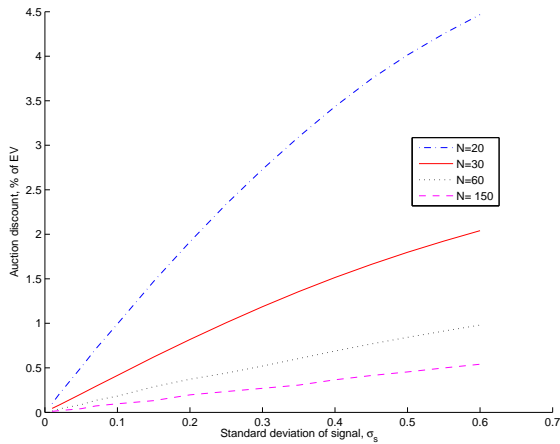
**Figure 2: Bidding Functions**

Equilibrium bid  
as a function of signal for different numbers of risk-neutral participants  $N$ .



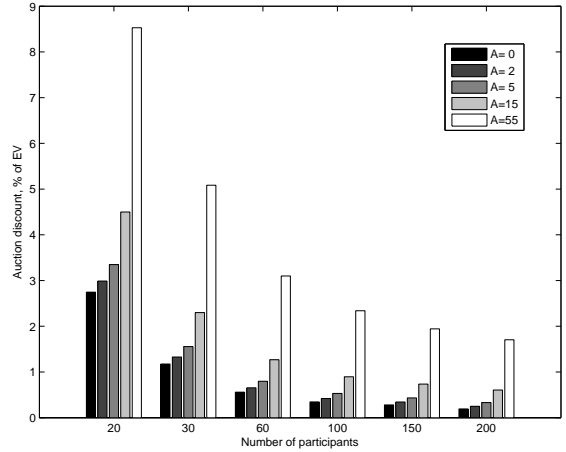
**Figure 4: Signal Quality and Discount**

Equilibrium expected discount for different values of noise  $\sigma_S$  and number of risk-neutral bidders  $N$ .



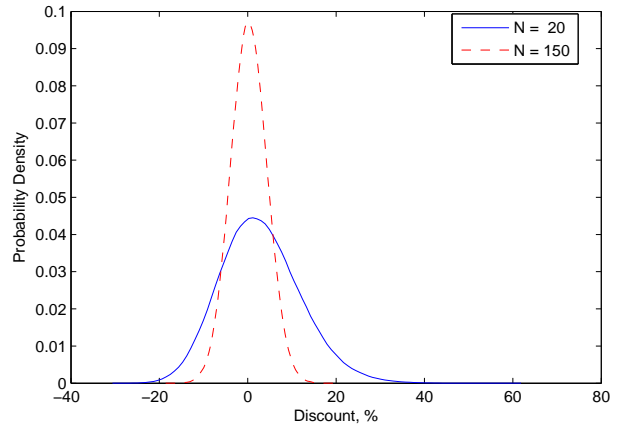
**Figure 3: Discount and Risk Aversion**

Expected auction discount for different numbers of bidders  $N$  and different risk aversion.



**Figure 5: Discount, % of EV**

Probability distribution of auction discount for  $N = 20$  and  $N = 150$ .



and getting an allocation, the expected profit will be \$0.50 when the number of bidders  $N = 20$ , and  $-\$1.00$  when  $N = 150$ .

An apparently sophisticated investor may calculate the expected profits to bidding as follows: The probability of winning is  $15/20 = 0.75$  when  $N = 20$  and  $15/150 = 0.10$  when  $N = 150$ . Therefore the expected profit to participating is  $\$0.50 \times 0.75 = \$0.375$  when 20 bidders participate; and  $-\$1.00 \times 0.10 = -\$0.10$  when 150 bidders participate. Since  $N = 20$  and  $N = 150$  are equally likely, it appears reasonable to calculate the expected profit to participating in the auction as

$$\frac{1}{2} \times \$0.375 + \frac{1}{2} \times \$ - 0.10 = \$0.1375.$$

Note that aggregate total expected profit to all the participants taken together is given by:

$$\frac{1}{2} \times \$0.375 \times 20 + \frac{1}{2} \times \$ - 0.10 \times 150 = \$ - 3.75.$$

In other words, while each bidder expects an average profit of \$0.1375 from participating in the auction, collectively the expected profit to all those who participate is  $-\$3.75$ . Obviously something is wrong with the calculations given above. The mistake is that the bidder did not correctly take into account the fact that whenever she herself participates, it is more likely that others are participating as well, or in other words when she participates  $N = 150$  is more likely than  $N = 20$ .

In order to correctly calculate the conditional probabilities, it is convenient to assume (without loss of generality) that  $N$  bidders are chosen at random from the pool of all potential participants, i.e., 150. Then, the probability of being chosen to bid when  $N = 20$  is  $20/150 = 0.13$ , and the probability of being chosen to bid when  $N = 150$  is  $150/150 = 1.00$ . The correctly computed ex-ante expected profit to each bidder is given by:  $\frac{20}{150} \times \$0.375 + \frac{150}{150} \times \$ - 1.0 = -\$0.025$ . Hence the collective expected profit of all 150 potential bidders is  $150 \times \$0.025 = -\$3.75$  same as what we computed earlier.

#### 4.2. Dynamic updating

Now, consider an economy populated by  $M$  potential “naive” investors. Each period  $t$ , each investor  $i$  faces fixed cost of participating in an auction  $c_i$ , and receives a private signal  $s_i$  about the true value. These investors are “naive” in the sense that if they choose to participate, they simply bid their valuation, or follow another bidding strategy, such as shaving their bids by a fixed amount, that does not change from auction to auction, and only depends on the private signal<sup>33</sup>.

They decide whether to participate based on their expectation of return in the auction, minus the fixed cost. Their expectations of return to participation is adaptive, and is equal to a weighted average of the return on all past auctions that they know about, and their own return on the auctions they have personally participated in.

Now, individual participation and observed returns to investors in these auctions will vary. Due to the bias inherent in the “let’s make a deal” example, however, any investors who have not yet participated in an auction will overestimate their returns to participation, and after a short initial period of higher discounts and lower participation, there will be a period of negative returns and high oversubscription. This period will continue until either (i) sufficiently long “bad” history is established, or (ii) sufficiently many investors learn not to participate based on their own experience, at which time they will stay away, and only a similarly long history of positive returns could induce them to participate again.

However, since the issuers are highly averse to a risk of auction failure, and since at this point auctions would (again) have low subscription and high discounts, they offer no advantages to issuers over either fixed price or book building offers, and thus issuers would prefer other methods, and such a positive history would never be established. This is observed in practice as auction failure.

There is, however, a possible compensating effect: the above reasoning relies upon assumption of “naive” investors; perhaps more sophisticated investors could step in and provide the demand when naive investors decide to stay out? In what follows, we argue that it is unlikely to be the case<sup>34</sup>.

<sup>33</sup>Kagel et al. (1995) found that in an experimental setting “bidders fail to respond in the right direction to more rivals”.

<sup>34</sup>Munger mentions in Poor Charlie’s Almanack (2006, page 18) that he avoids auctions since “The problem with closed bid auctions is that they

### 4.3. Structural Risk in IPO Auctions

The folk wisdom is that wider participation IPO auctions must necessarily be in the interest of the issuer, due to better price discovery, increasing revenue and decreasing risk. However, in practice imprecise valuation is not the only source of aggregate risk in IPO auctions. Much of it comes from the features of the bidding environment itself, such as the variation in the number and strategies of other bidders. This variation has historically been very high.

For example, when Japan auctioned off parts of its railway system, the 1993 auction of Japan Railway (JR) East drew 18,670 bidders, while the 1996 auction of JR West drew only 3,395 bidders, a decrease of more than 80%. 335,000 JR West shares (20%) were left unsold. When Argentina auctioned off its first telecommunications company, Telefonica, in December, 1991, it hoped for at least 80,000 bids from local investors but received more than 100,000. When it auctioned off its other telecommunications company, Telecom, just a few months later, the auction drew more than 270,000 applications from local investors.

Amihud et al. (2003) found large fluctuations in the number of bidders for IPO auctions in Israel. Similarly, Kandel et al. (1999) looked at 28 auctions over 3 years in Israel and found that orders ranged from 1,388 to 13,518<sup>35</sup>. Lin et al. (2003) and Hsu and Shiu (2004) report wide fluctuations in bidder numbers for Taiwan's IPO auctions. There is also evidence of variation in the demand for Singapore auctions<sup>36</sup>. Subscription levels ranged from the Vickers Ballas auction, which was 1,300% oversubscribed (at the minimum bid), to Sunright, which was 82% undersubscribed. The number of bids ranged from 1,128 for Eng Wah to 162,492 for Singapore Telecom. In the same month that Singapore Telecom's auction was heavily oversubscribed, the auction of another well-respected Asian telecommunications company, Korea Telecom, was 90% undersubscribed (i.e. received orders for only 10% of the available shares). While some of these variations in participation levels would have been anticipated, there would have been some surprises.

We illustrate the effect of structural risk by considering an environment similar to the baseline model, but with added uncertainty about the number of bidders. For simplicity assume that all bidders are identical and there are  $L$  potential bidders, out of whom either  $N_1$  or  $N_2$  get to participate, with ex ante probabilities  $p$  and  $1 - p$ .

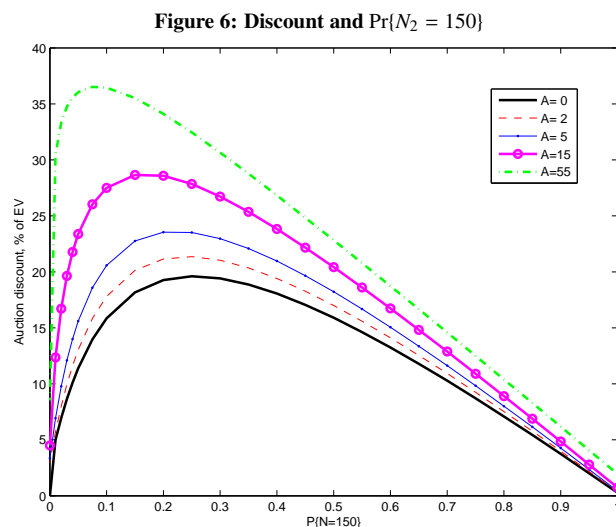


Figure 6 gives the expected discount when the probability of  $N_1 = 150$  varies from 0 to 1 for different values of risk aversion of bidders. The expected discount is small when there is no uncertainty about the number of bidders. However when the bidders face additional risk from underestimating the competition (i.e., there is a positive probability of  $N = 150$ ), the expected discount increases. It is highest when the uncertainty about the number of bidders is high, and the risk aversion of the bidders is also high. Restricting the number of participants to 20 bidders in this case would result in an outcome clearly superior for the issuer – even though it means abandoning openness, which is lauded as one of benefits of auctions.

are frequently won by people making a technical mistake, as in the case with Shell paying double for Belridge Oil.” See also Dyer et al. (1989).

<sup>35</sup>Multiple orders were allowed, so the number of orders might overestimate the number of bidders.

<sup>36</sup>Data available on request



In addition to high discounts, randomness in participation greatly increases the variance of outcomes. To fully appreciate the risk faced by investors, consider the case where the probability of  $N = 150$  is 50%, and the coefficient of risk aversion  $A = 2$ . In this case, the return to a winning bidder is positive about half of the time, mostly when the number of bidders is below average. In the low-participation auctions, winners have an expected rate of return of 66.6%, with 75% of such auctions returning at least 56.1% and 25% returning 76.1% to the winning bidders, while in the high-participation auctions the situation is very different: the winners take losses in 97.3% of the auctions, with an average return of -7.4%. In 75% of the high-participation auctions, winners lose more than 4.8%, with a 25% chance of losing 10.0% or more. Thus, although the return is positive for winning bidders on average, there is substantial risk.

It is necessary to note that there are ways of designing auctions in order to control this risk: for example, requiring bidders to indicate their intention to bid before starting an auction, with a subsequent revelation of the number of participants prior to bidding, would reduce both the risk the bidders would face and the return they would demand. However, such practices so far have not been used for auctions of IPOs<sup>37</sup>.

Auctions are not the only IPO method for which there have been fluctuations in the number of participants, of course. However, the timing of sealed bid auctions and their method for determining the offer price make unanticipated variations in subscription levels more problematic than for the other two main IPO methods. With fixed price public offers, the subscription level affects a person's chance of getting shares but not her return, conditional on getting shares, since the subscription level does not affect the offer price. With book building, the underwriter observes the subscription level as well as the 'bids' and can then set the price, taking the subscription level into account.

In addition to uncertainty about the number of bidders, disruption can result when some bidders place noncompetitive (i.e. arbitrarily large) bids. In a uniform price auction, such "free riding" places the bidder first in line for shares but may have little effect on the clearing price. However, each such bid reduces the pool of shares available to investors who actively participate in price discovery. If other bidders do not anticipate the free riders and adjust their bids accordingly, their expected return will be lowered. If other bidders have rational expectations regarding the distribution from which the number of free riders comes, they will shave their bids accordingly, lowering the expected proceeds to the issuer. As with uncertainty over the total number of bidders, uncertainty over the number of free riders increases risk for both issuers and investors, even in an equilibrium in which everyone's expectations are correct on average. Thus we argue that uncertainty over the number of bidders, their information sets or their bidding strategies can lead to more underpricing, more risk and less accurate pricing.

#### 4.4. Summary

In this section, we first modeled auctions in a frictionless environment in which all eligible bidders are endowed with valuable private signals and bid in every auction. In this case auctions are underpriced on average, but not by much when bidders are risk neutral and there are sufficiently large numbers of bidders. Risk aversion on the part of bidders increases the average underpricing, but auction discounts are still relatively low. This is the oft-cited auction solution in which more bidders leads to a more efficient result, with underpricing largely vanishing once sufficient numbers of investors bid. Hence, in a frictionless world with no information generation costs, auctions lead to highly efficient pricing as long as they are open to large numbers of informed, sophisticated bidders.

We next examined some more realistic settings, beginning with one in which there is uncertainty over the number of bidders. Bidding becomes difficult when there is uncertainty about the number of bidders, how much they know and what strategies they will follow, leading to more risk, more underpricing and less efficient price discovery. Free riders (those who choose to bid very high to be first in line, without investing in information generation) add risk for other bidders and for the issuer, with the issuer ultimately having to underprice more because of the presence of potential free riders. That suggests a role for monitoring bidders and limiting their access to reduce the free riding problem.

Last, we showed that it is not easy to bid in auctions, and that even sophisticated bidders can make mistakes. When investors make bidding errors, or when they follow suboptimal strategies such as return-chasing, costs are imposed not only on those bidders themselves but on all auction participants and ultimately on issuers. The bidding errors and

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<sup>37</sup>The Google, Netsuite, and Rackspace IPO auctions in the U.S. required bidders to acquire unique bidder IDs before the auction began, but the total number of unique IDs awarded was not announced.

problems that we have shown in this section appear to match the problems that have occurred in practice in many auctions around the world, as we will explore in more detail in the next section.

## 5. Empirical Evidence

In this section we first provide some anecdotal evidence supporting the arguments in the earlier section. We then examine the evidence from Singapore in greater detail. Finally we discuss the US experience with auctions for Treasury securities.

### 5.1. Anecdotal Evidence on Initial Returns

It is necessary to note that auctions often lead to very large first day gains or losses. [Appendix C.1](#) lists examples of IPO auctions that have led to large first day gains, while [Appendix C.2](#) gives examples of negative first day returns. One example is the 1993 auction of Japan Railway East, which was in such strong demand that it was heavily oversubscribed and yet traded as high as 70% above the auction clearing price on its first day. In contrast, the later auction of Japan Railway West attracted only about one-fifth as many bidders and was 20% undersubscribed. When El Al, the Israeli Airline, was auctioned off in 2003, the IPO was widely considered a hot offering. However, demand was so unexpectedly low that orders barely covered the minimum number of shares. Within days, the stock was trading for more than double the auction price (a 112% increase) on the Tel Aviv Stock Exchange, and investors were complaining that the process had been unfair, because more people would have bid if they had known that the auction price would be so low. However, by the very nature of sealed bid auctions, no one knows how many others have placed bids until after the bidding period has closed, when it is too late to respond.

Argentina offers an example of how success with one auction can lead to problems with the next. Argentina began a massive privatization program with the auction of shares in Telefonica de Argentina in December, 1991. Institutional demand was lower than expected, since many professional investors thought that the minimum bid price was too high. However, massive interest by retail investors drove the auction clearing price to 45% above the minimum bid. The stock rose another 20% during aftermarket trading, and the auction was described as a "smashing success". The next privatization, for Argentina Telecom, came less than four months later. Because the Telefonica auction had been such a success, many were eager to cash in on the Telecom auction. Bids totaled almost 6 billion pesos, although the government had only hoped to raise 1 billion pesos. The auction price was bid up to almost twice the reservation price, due to the strong demand from local investors. The initial return on Telecom's IPO (based on the first day's closing price) was 3.6%, which means that the stock would be considered fairly accurately priced in most academic studies.

But the auction price was unsustainable. Many investors had funded their purchase with 90 day margin loans, and by the time those loans were due, the stock price had fallen far enough that many discouraged investors chose not to meet margin calls on their Telecom shares, while others sold other shares to meet their Telecom margin calls. Brokerages had to dump more and more shares onto the market because of missed margin calls, causing a general market crash and the cancellation of up to 20 other planned IPOs in Argentina. Telecom was later described as "viciously overpriced" because, according to a banker at Banco de Galicia, "Everyone had seen how well Telefonica (the other telephone privatization) had gone, and their total analysis was 'if Telefonica was a sell-out then Telecom will be too'. What happened was that the Dutch-auction system exacerbated things because people pushed up their price to make sure they would get shares."<sup>38</sup>

Thus, there are many examples of extreme initial returns resulting from IPO auctions. These do not prove that auctions are inferior to other issue methods, since other methods have also led to large positive or negative initial returns. Nevertheless, these examples show that the pricing accuracy of the sealed bid IPO auction method should not be taken for granted. Regarding the question of whether auctions lead to less underpricing, relative to book building, the overall evidence is surprisingly weak, since there is little data that allows a direct comparison. The relevant comparisons that have been made to date are the following:

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<sup>38</sup>"Argentina's Stock Regulator Faces Daunting Task", The New York Times; August 24, 1992, Section D, p. 3.

- France: Auctions co-existed with a restricted, sub-optimal form of book building (a sequential hybrid, rather than ‘open pricing’ which is a simultaneous hybrid) until 1999, when more standard book building was allowed and auctions were quickly abandoned. [Derrien and Womack \(2003\)](#) found that the differences in underpricing between auctions and book building were “small and statistically insignificant when examined unconditionally” (page 47), but that auctions were better than the sequential hybrid book builds in their “ability to incorporate more information from recent market conditions into the IPO price” (abstract), thus confirming that the differences were due to the regulatory restrictions on book building that were later eliminated.
- Japan: Auctions were required for many years but vanished quickly in 1997, once book building was allowed. Thus, the two methods did not overlap but were used in close succession. [Kutsuna and Smith \(2004\)](#) found a small but statistically significant increase in initial returns under book building, and also found that a wider range of companies, including younger start-ups, were able to go public under book building.
- India: Regulations were changed in 2005 to prohibit book building, replacing it with auctions. [Bubna and Prabhala \(2009\)](#) find that auctions led to more underpricing, relative to book building.

The evidence is inconclusive, since auctions have led to less underpricing in Japan, more underpricing in India and to no statistically significant difference in France, relative to book building.

## 5.2. IPO Auctions in Singapore

The available data on auctions is sparse and not easily amenable to rigorous quantitative analysis using statistical methods, since most countries that have tried IPO auctions gave up on them after a few years, leading to small samples. For example, the influential [Kandel, Sarig and Wohl \(1999\)](#) paper is based on only 28 IPO auctions in Israel, while [Degeorge, Derrien and Womack \(2007\)](#) examine only 19 auctions in the U.S. Moreover, data on participation levels are often unavailable.

Singapore’s IPO auctions during 1993-1994 present an interesting natural experiment and an illustration of some of the potential issues that we believe is of general relevance. We have data on the full sample of all 20 uniform price IPO auctions in Singapore, and will attempt a quantitative characterization of that data in this section.

The lessons from the Singapore experience are relevant for several reasons. First, Singapore is a sophisticated financial center whose banking and security markets are well regulated. One example of its technological sophistication is the fact that IPO auction bidders beginning in 1993 could place their bids through automated teller machines (ATMs), thus making those auctions as widely accessible as online internet auctions are today. The Singapore stock market in 1993 was fairly well developed and active, with two active exchanges, 241 public companies traded, and S\$280 billion of average daily dollar transaction volume<sup>39</sup>.

Singapore’s uniform price auctions were hybrids and thus were well suited to reduce the impact of free riders, since uninformed investors could also participate, without specifying a price, through the simultaneous fixed price tranche. Therefore, if there is evidence of free riders including return chasers becoming an issue in hybrid uniform price auctions, they are likely to be even more of an issue in ‘pure’ uniform price auctions.

### 5.2.1. The Data

We use data on all 20 Singapore IPO issues that were held during 1993-1994, which include 20 uniform price hybrid auctions (tenders) and 31 pure fixed price issues<sup>40</sup>. The available statistics include size of individual tranches (fixed price, tender, employee, and private placement), number of shares outstanding and offered, IPO clearing price, interval data on bids collected (number of bids and number of shares bid in a given price range), obtained from the Stock Exchange of Singapore.

In addition we use market performance data from Bloomberg Finance L.P., and an archive of Singapore English-language financial press available through Lexis-Nexis Academic.

The main shortcoming of our data is its fairly low duration – there were only 20 IPO auctions conducted in Singapore during those two years, and the method has never been tried there again.

For each of auctions  $t = 1..T$  we know:

<sup>39</sup>Daily average exchange rate in 1993 US\$1 = S\$1.57

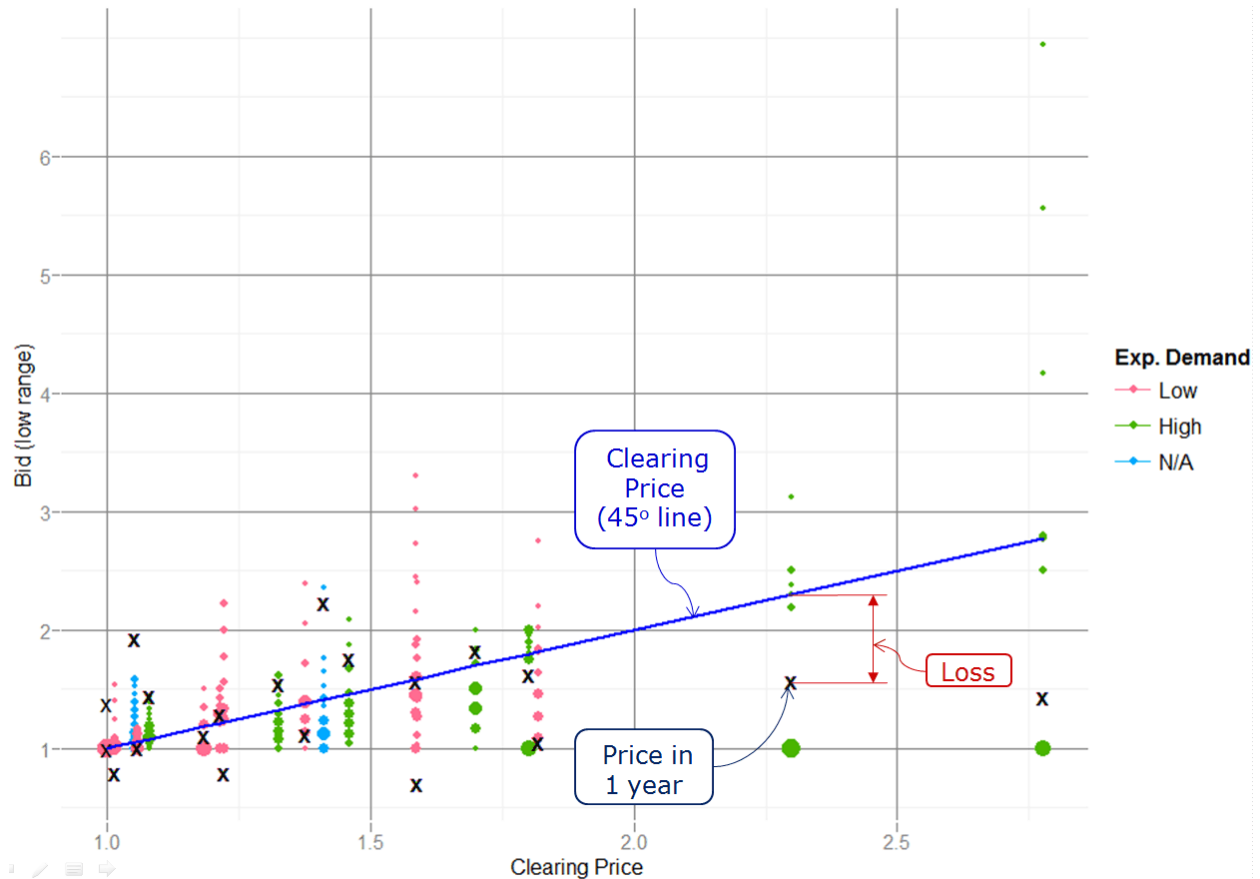
<sup>40</sup>A list of these is available upon request, along with a detailed description of the regulations.

- $J_t$  bid intervals  $[\underline{b}_{jt}, \bar{b}_{jt}]$ ,  $\bar{b}_{J_t} = +\infty$
- $q_{jt}$ : the total number of shares applied for in  $[\underline{b}_{jt}, \bar{b}_{jt}]$
- $n_{jt}$ : the total number of applications in  $[\underline{b}_{jt}, \bar{b}_{jt}]$
- $m_t$ : Clearing price

Figure 7 illustrates the bid distribution in the 20 auctions. Each circle represents the low point  $\underline{b}_{jt}$  of a range for a group of bids in a particular auction; circle size is proportional to the relative size of that group within the auction. Fixed price is normalized to 1 for all auctions. “x” denotes the price after 1 year. Auction clearing price  $m$  is on the horizontal axis. Blue solid line is a “45-degree” line  $\underline{b}_{j,t} = m_t$  and denotes locations of the marginal winning bids.

**Figure 7: Bidding in Singapore IPOs**

Each circle represents the low point of a range for a group of bids in a particular auction; circle size is proportional to the relative size of that group within the auction. Fixed price is normalized to 1 for all auctions. “x” denotes the price after 1 year. Auction clearing price on the horizontal axis. A “45-degree line” denoting locations of the marginal winning bids in blue. “High” and “Low” expected demand auctions are ranked according with demand forecasted using the specification in (3).



### 5.2.2. Singapore IPOs: a Short History

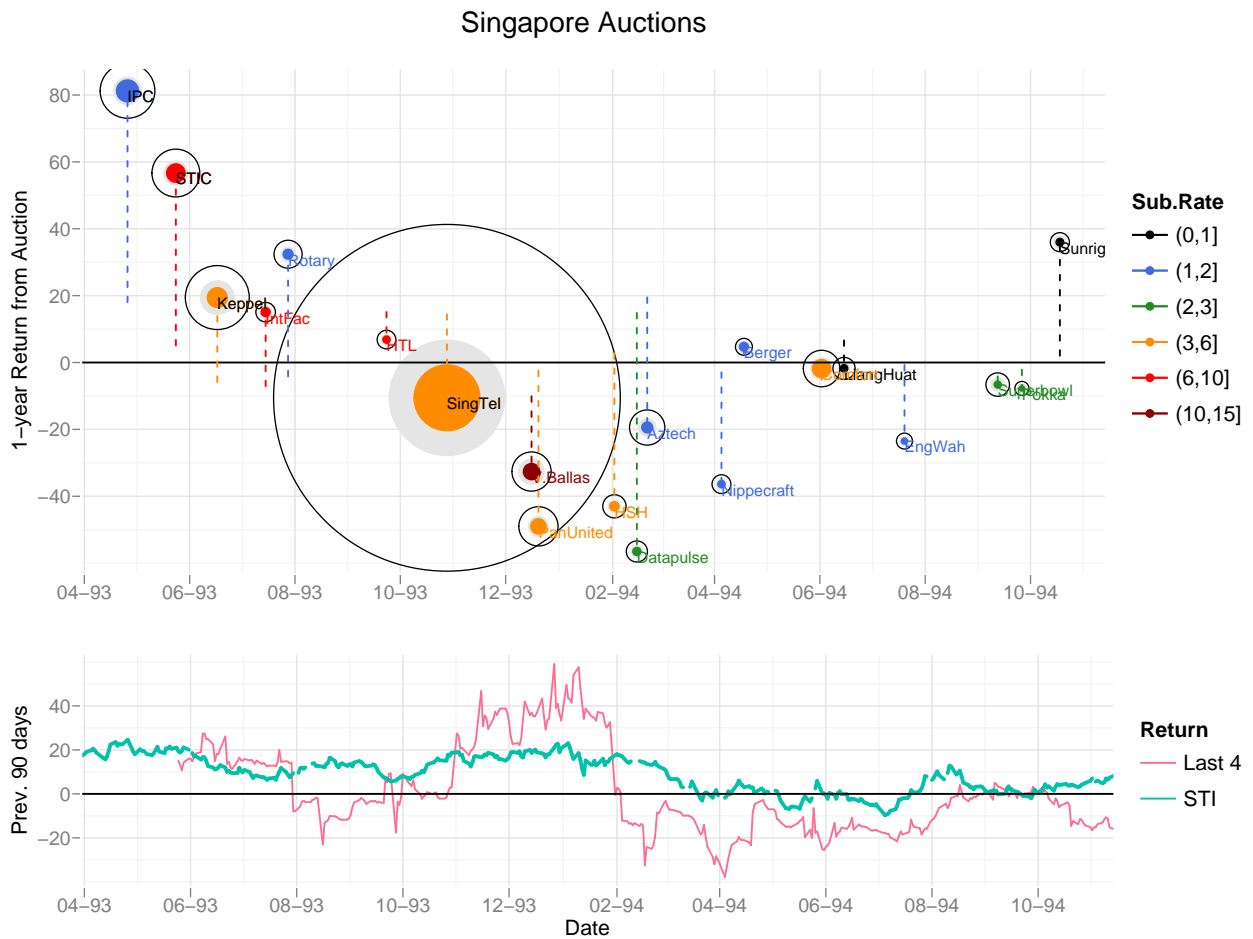
The hybrid auction scheme was first introduced as an option for Singapore on July 29, 1991, when companies were allowed to offer part of the issue in a “Dutch” (discriminatory) auction. It, however, has not gained much popularity, with only one Dutch tender IPO (Singapore Computer Systems) in 1991, and one more (Keppel Integrated

**Figure 8: Singapore IPO Issues: Size, Time, and Annual Returns**

Top panel: 1-year market adjusted return vs. subscription closing date. Color: subscription rate (ratio of shares applied to shares offered). Colored circle proportional to value of the tender tranche. Gray area proportional to fixed price tranche. Thin solid circle proportional to market value (all evaluated at the fixed tranche price). Thin dotted line shows aftermarket movement from first day close.

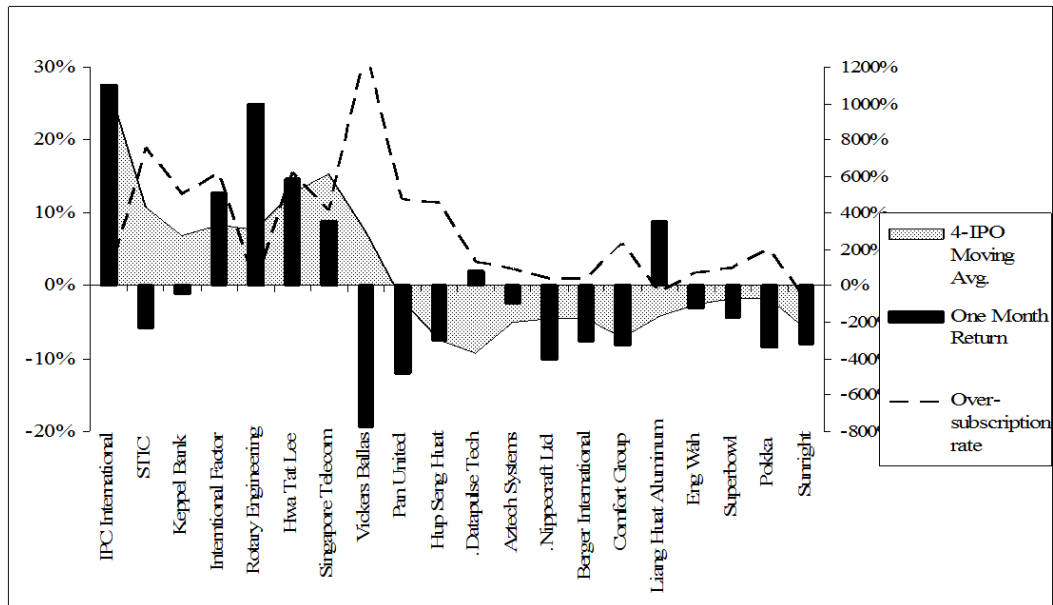
Bottom panel: Thick green line: 90-day cumulative return on the STI index. Thin red line: 90-day cumulative return on a buy-and-hold portfolio of last 4 tender IPO shares, purchased at tender price (equally weighted)

Sources: Stock Exchange of Singapore and Bloomberg Finance L.P.



**Figure 9: One month buy-and-hold returns and subscription levels in Singapore**

All 1993-1994 auctions are ordered by date. One month raw returns are the returns to winning bidders that held their shares for 30 days in the aftermarket. The 4-IPO moving average is the average return on the last 4 offers (or all previous, if less than 4). The oversubscription rate is in percent – an offering that was 60% oversubscribed received orders for 1.6 times the shares available.



Engineering) in 1992<sup>41</sup>. No other IPO auctions took place in Singapore until February 1993, when an alternative uniform price (“French”) auction system was introduced.

A timeline showing Singapore IPO auctions’ size, 1-year returns and subscription levels in 1993-1994 is shown in Figure 8 and Table 2.

Figure 9 provides visual evidence of how Singapore’s auctions evolved over time by plotting one month returns and subscription levels for all of Singapore’s auctions, ordered chronologically. Although there were variations, the returns and participation levels for IPO auctions fell over time. Investors would have made money on five of the first seven uniform price auctions (known as tenders) in Singapore, if they had bought at the auction strike price and sold after the shares had traded for one month. The average raw return on the first seven offerings was 11.7%, for this holding period, and the average oversubscription ratio was 4.2 (420% oversubscribed). However, the returns were negative for seven of the last eight auctions done in Singapore, with an average one-month return of -5.1% for these auctions (tenders)<sup>42</sup>. People noticed the poor performance, complaining that auctioned IPO shares were falling below their auction strike price on the aftermarket and joking that they must be catching a new disease called “tenderitis”<sup>43</sup>.

While the oversubscription level for the last eight auctions was 0.7, which means that offerings were still on average 70% oversubscribed, this was substantially lower than the average of 420% oversubscription for the first 7 auctions. Two of the last five auctions were undersubscribed, including the last auction, for Sunright, which received bids for only 18% of the shares available. The average number of bidders per auction was 48,095 for the first seven

<sup>41</sup> See Hameed and Lim (1998)

<sup>42</sup> A similar pattern occurred for the 19 U.S. IPO auctions that have been lead-managed by WR Hambrecht from 1999-2007 analyzed in Degeorge et al. (Forthcoming). For the first 9 IPOs, from 1999-2003, the mean initial return is 29.1% with a standard deviation of 84.3%. Excluding Andover.net, which is arguably an outlier, the mean and standard deviation are 1.3% and 11.5%. For the next 10 IPO auctions from 2004-2007, the mean initial return is -0.1% with a standard deviation of 5.3%. This less attractive performance, from the standpoint of investors, in the second half of the sample may at least partially explain why there have been no OpenIPOs since May, 2007. However, there have since been two other U.S. IPO auctions lead-managed by other investment banks - Netsuite in December, 2007 with an initial return of 36.5% and Rackspace in August, 2008 with an initial return of -19.9%.

<sup>43</sup> “New strategies needed for future IPOs”, Ven Sreenivasan, Singapore Straits Times, p. 13, February 3, 1995.



**Table 2: Singapore Tender IPO Issues: Subscription and Returns**

Subscription rate is defined as a ratio of the number of shares applied for in a tender issue to the number of shares available as of the closing date of the subscription period. The raw returns are total returns to a bidder who purchased a share at the auction clearing price and sold at the close of the corresponding period. Adjusted returns are defined as the difference between raw and market returns (as measured by the Straits Times Index) in the corresponding period. All market returns are adjusted for dividends.

Company	Date	Subscription Rate		Return							
		Fixed Price	Tender	1 day		1 week		1 month		1 year	
				Raw	Adj.	Raw	Adj.	Raw	Adj.	Raw	Adj.
IPC Corporation	04/26/93	3.9	1.2	22.5%	18.0%	18.1%	12.5%	27.5%	24.2%	81.3%	51.2%
Spore Tech Industrial Corp.	05/24/93	3.9	8.6	4.2%	5.1%	-2.5%	-0.2%	-5.8%	-2.2%	56.7%	36.1%
Keppel Bank	06/17/93	16.1	6.0	-5.7%	-5.8%	-8.6%	-6.9%	-1.1%	-4.8%	19.4%	0.4%
International Factors	07/15/93	29.2	7.2	-4.8%	-7.1%	-2.4%	-8.7%	12.7%	-0.9%	15.1%	-11.6%
Rotary Engineering	07/28/93	8.1	1.2	2.8%	-4.2%	2.8%	-6.4%	25.0%	11.4%	32.4%	6.0%
Hwa Tat Lee Holdings	09/23/93	41.0	7.2	19.6%	15.1%	12.7%	6.5%	14.7%	9.9%	6.9%	-5.6%
Singapore Telecom	10/28/93	3.0	5.1	15.0%	14.5%	6.1%	10.8%	8.9%	9.6%	-10.6%	-14.0%
Vickers Ballas	12/16/93	30.9	14.0	-6.0%	-10.1%	-8.7%	-14.4%	-19.3%	-20.3%	-32.6%	-21.6%
Pan United Corporation	12/20/93	16.5	5.8	4.0%	-2.4%	-5.0%	-11.1%	-12.0%	-14.2%	-49.0%	-37.6%
Hup Seng Huat	02/02/94	32.7	5.6	1.0%	2.8%	0.0%	-1.7%	-7.5%	-0.1%	-43.0%	-27.0%
Datapulse Technology	02/15/94	34.0	2.3	15.0%	14.9%	10.0%	12.5%	2.0%	14.6%	-56.5%	-41.6%
Aztech Systems	02/21/94	13.6	1.9	17.4%	19.5%	15.7%	20.5%	-2.5%	10.4%	-19.4%	-3.7%
Nippecraft	04/05/94	11.2	1.4	2.7%	-2.9%	-2.7%	-9.5%	-10.0%	-17.2%	-36.4%	-29.2%
Berger International	04/18/94	19.6	1.4	4.7%	2.8%	-5.3%	-4.4%	-7.6%	-8.7%	4.7%	16.0%
Comfort Group	06/02/94	24.4	3.3	-4.5%	-5.1%	-5.4%	-4.6%	-8.1%	-6.4%	-1.8%	5.2%
Liang Huat Aluminium	06/15/94	8.5	0.6	4.4%	6.6%	3.5%	6.3%	8.8%	8.7%	-1.8%	6.4%
Eng Wah Organization	07/20/94	4.4	1.8	0.8%	-0.7%	-5.3%	-7.1%	-3.0%	-6.9%	-23.5%	-16.9%
Superbowl	09/12/94	2.3	2.0	-3.3%	-4.1%	-6.6%	-7.4%	-4.4%	-7.2%	-6.6%	2.6%
Pokka	09/26/94	8.1	3.0	-0.7%	-2.1%	-8.5%	-9.5%	-8.5%	-8.5%	-7.7%	1.0%
Sunright	10/18/94	1.2	0.2	2.0%	2.0%	-3.3%	-3.4%	-8.0%	-1.7%	36.0%	48.3%
<b>Total</b>											
Average		15.6	4.0	4.6%	2.8%	0.2%	-1.3%	0.1%	-0.5%	-1.8%	-1.8%
Standard Deviation		12.4	3.4	8.7%	9.1%	8.3%	9.6%	12.4%	11.5%	35.4%	25.6%
% Negative		-	-	30.0%	50.0%	60.0%	70.0%	65.0%	65.0%	60.0%	50.0%
Min		1.2	0.2	-6.0%	-10.1%	-8.7%	-14.4%	-19.3%	-20.3%	-56.5%	-41.6%
Max		41.0	14.0	22.5%	19.5%	18.1%	20.5%	27.5%	24.2%	81.3%	51.2%

auctions<sup>44</sup> and 6,494 for the last eight. The decrease in returns is similar if we calculate the one month returns relative to the Straits Times Index (blue chips) or Sesdaq Index (smaller, younger companies), or if we use two month returns. It would appear that for investors who were learning and updating their priors over time, auctions became less attractive.

We argued in Section 4.3 that a large number of unanticipated bids will result in the auction clearing price being too high, whereas a surprisingly low subscription rate will lead to large underpricing. We further observed that unanticipated free riders, including return-chasers, may make auctions less attractive for sophisticated investors. We examine the data in three steps to see whether there is support for these conjectures.

### 5.2.3. Evidence of Return-Chasing Behavior

Here we investigate what factors affect popularity of a particular IPO auction and whether there is evidence of return-chasing behavior.

First, we check whether high returns to participating in the preceding auction leads to a higher participation rate in the current auction, using the following regression (Equation 1):

$$S_{Ai} = \alpha_0 + \alpha_1 S_{Fi} + \alpha_2 r_{i,lag30d} + u_i \quad (1)$$

where:

- $S_{Ai}$  is the subscription rate in the  $i^{th}$  auction;
- $S_{Fi}$  is the subscription rate in the fixed price tranche, included here to control for unobserved issue-specific factors affecting the demand for shares;
- $r_{i,lag30d}$  is the return that would have been obtained by buying in the  $(i-2)^{nd}$  auction and selling one month after trading begins.

Since in Singapore the auction and fixed price tranches occurred simultaneously (as opposed to countries like Taiwan where tranches took place sequentially,) fixed price tranche demand is a good proxy of overall demand at the time of the auction.

For the return from a previous auction,  $r_{i,lag30d}$ , we use the return from 2 auctions ago because the one month return on the  $(i-1)^{st}$  auction is in general not available by the time the  $i^{th}$  auction is open for bidding<sup>45</sup>. We also consider the following variation (Equation 2) of equation (1) above:

$$N_{Ai} = \alpha_0 + \alpha_1 N_{Fi} + \alpha_2 r_{i,lag30d} + u_i \quad (2)$$

where:

- $N_{Ai}$  is the number of persons bidding in the  $i^{th}$  auction divided by the dollar value of shares offered in the auction tranche, at the reservation price;
- $N_{Fi}$  is the number of persons bidding in the  $i^{th}$  auction's fixed price tranche divided by the dollar value of shares offered in the fixed price tranche.

The results are shown in Table 3, and seem to indicate the presence of "return-chasers". The coefficients for both variables have the predicted sign and are significant at the 1% level. The auction subscription rate and number of bidders are significantly positively related to our proxy for overall demand, as expected. And, after controlling for demand, the subscription rate or number of bidders is significantly positively related to the return on the second-to-last auction, which is a sign of return-chasing. The  $R^2$  is 60% for Equation 1 and 39% for Equation 2.

Thus, both higher underlying demand and a higher return to participating in a recent auction lead to higher participation in the current auction.

<sup>44</sup>The average is 23,196 for the first six auctions, excluding the unusually large Singapore Telecom offering.

<sup>45</sup>In two cases we had to use the 30 day return on the  $(i-3)^{rd}$  auction since the return on the  $(i-2)^{nd}$  auction was not available when the  $i^{th}$  auction opened.

**Table 3: Determinants of Auction Subscription in Singapore**

The dependent variable is the auction subscription rate (ratio of the total number of shares requested in all bids to the number of shares offered) for Equation 1 and the number of bidders in the auction for Equations 2 and 3. The subscription rate or number of bidders in the fixed price tranche are used to control for overall demand for the shares. Other controls: 90-day cumulative return on a buy-and-hold portfolio of last 4 tender IPO shares, purchased at tender price (equally weighted), and an increased news coverage dummy (see Section 5.2.3 for details).

	Eq. 1	Eq. 2	Eq. 3
Subscr. rate in fixed tranche	0.18*** (4.27)		
Number bidding in fixed tranche		0.03*** (3.29)	
1 month ret. on next-to-last auction	14.18*** (3.5)	-.001*** (2.26)	
90-day ret. of 4-auc. portfolio			11.05*** (4.14)
Increased news coverage			2.72** (2.28)
Constant	0.74 (0.85)	-0.00 (0.77)	3.18*** (5.06)
R <sup>2</sup>	0.60	0.39	0.56
Obs.	18	18	18

*t* statistics in parentheses

\*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

It is also of interest how much of the variation in demand could be explained by the factors that were observable by the participants in real time, i.e. before the subscription date. Therefore in the following specification we replace the unobservable (to auction participants) characteristics of the simultaneous fixed price tranche with a news coverage variable<sup>46</sup> (Equation 3):

$$N_{Ai} = \alpha_0 + \alpha_1 \Delta NEWS_i + \alpha_2 r_{i,lag90d}^p + u_i \quad (3)$$

where:

- $\Delta NEWS_i$  is a dummy variable equal to 1 if the current IPO receives more news coverage<sup>47</sup> than the median of all the past auctions, and 0 otherwise
- $r_{i,lag90d}^p$  is the cumulative 90-day return on an equally weighted buy-and-hold portfolio of shares offered in the past 4 auctions, purchased at the tender price<sup>48</sup>, on the last business day prior to the day of subscription

It is easy to see that these real-time variables explain somewhat over half of the variation in participation ( $R^2 = 56\%$ ), again suggesting that return-chasing was taking place. Again, the coefficient on recent auction return is positive and significant at the 1% level.

While a higher participation rate in the auction is positively related to a higher auction clearing price, the higher price may be “rational”, reflecting a higher intrinsic value of the issue over and above that reflected in the fixed price (and over and above the higher value reflected in fixed price tranche demand). This model predicts that when the intrinsic value of the offering is higher, both the auction clearing price and the initial return to winning bidders will be higher. It is therefore important to further investigate whether noise bidders adversely affected the environment.

#### 5.2.4. Bid Distribution and Future Returns

One reason for a high clearing price is naturally a high realization of the share value. Another possible reason for such results may be the presence of free-riders: bidders who do not engage in price discovery but instead name a very high price in order to obtain an allocation. In an asymmetric equilibrium with such free-riders (whether anticipated

<sup>46</sup>See Liu, Sherman and Zhang (2009) for analysis of the role of media coverage in IPOs.

<sup>47</sup>Measured by the number of articles that mention the IPO in Singapore business press in the 4 weeks before the subscription date

<sup>48</sup>Green line in Figure 8

or unanticipated) the distribution of bids will be mixed: the free-riders would bid high regardless of the underlying value, and the other bidders would bid according to their signals.

Cornelli et al. (2006) note that “in the case of IPOs, Ritter and Welch (2002) conjecture that overenthusiasm among retail investors may explain high first-day returns and low long-run returns. However, the extent to which the presence of irrational investors (motivated by “investor sentiment”) can account for these phenomena is controversial, not least because of the difficulty in empirically identifying the demand curves of different investor groups”. This difficulty presents a problem for us as well, since due to the multiple censoring of our dataset it is not possible for us to directly observe individual bids. However in what follows we present several quantitative results that seem to confirm the presence of naive investors’.

The number of bid ranges in our bid data and their breakpoints are auction-specific and do not allow for direct comparison between auctions. However, in presence of free-riders there should be aggregate effects: namely, their presence should increase the variance of the bid distribution and create positive skewness.

On the other hand, a high mean bid can be a signal of either high underlying value, or free-rider presence, or both. Therefore, controlling for the mean, we would expect free-riders to drive up auction prices relative to the underlying value, and potentially cause future negative returns. In line with prior reasoning, we would also expect free-riders to be more prevalent among smaller individual bidders<sup>49</sup>.

We use a two-step estimation procedure: first, we approximate the bid distribution in each auction by a separate lognormal distribution. This distribution choice allows us to capture changes both in the mean (potentially attributed to higher underlying value and overall, rational or irrational, level of excitement about the issue ) and in the skewness and variance (which both positively depend on the same parameter  $\sigma$ ). In addition, these parameters, unlike range statistics, can be compared across auctions.

We use maximum likelihood to estimate the bid distribution parameters:

$$(\hat{\mu}_t, \hat{\sigma}_t) = \operatorname{argmax}_{\mu, \sigma} \prod_{j=1}^{J_t} \left( F(\bar{b}_{jt} | \mu, \sigma) - F(\underline{b}_{jt} | \mu, \sigma) \right)^{n_{jt}}$$

where the observed values  $J_t, b_{jt}, n_{jt}$  are as described in Section 5.2.1.

Figure 10 shows the estimated  $\mu$  and  $\sigma$  for the applications distribution in the 18 auctions for which we have sufficient data<sup>50</sup>. As one can see, most losses characterize auctions with either a high  $\mu$ , or a high  $\sigma$ , or both, which is a picture that one would observe in presence of a large number of bidders who do not engage in price discovery.

Table 4, Panel A illustrates the relationship between the parameters of the applications distribution and future returns. Given the small sample size, a robust version of the estimation is presented in Table 4, Panel B, showing similar results. We can see from these tables that either a high  $\mu$ , or a high  $\sigma$ , or both, are significantly negatively related to one year returns on the offerings, as one would expect if the auction price and initial demand are influenced by a large number of bidders who do not engage in price discovery.

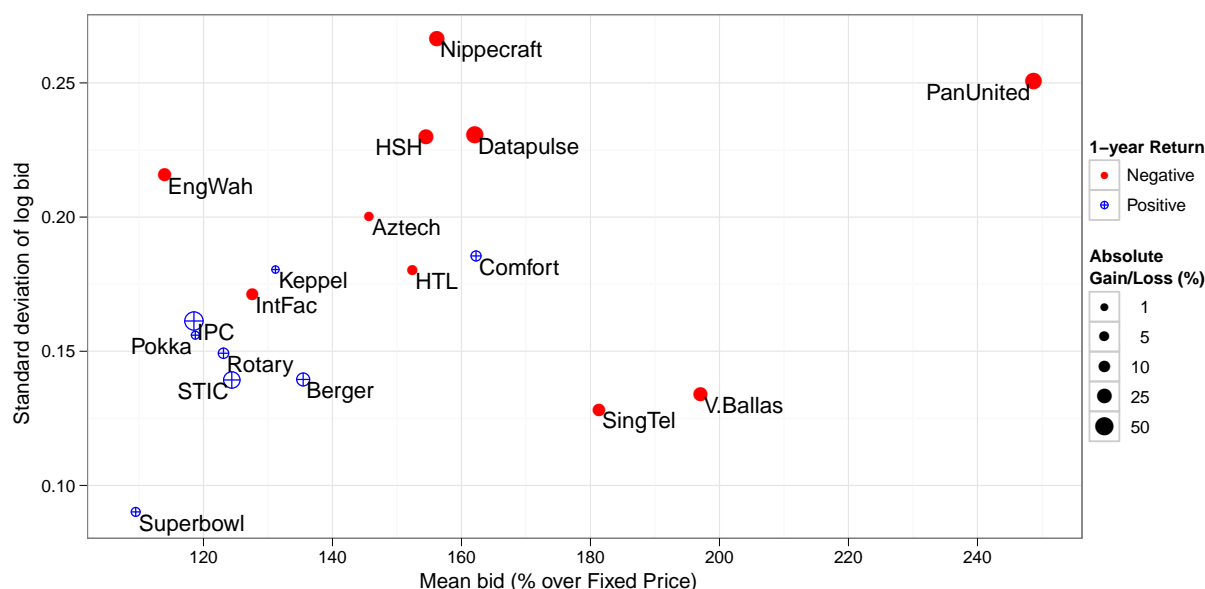
One last piece of evidence of the presence of free riders in our data is the analysis of the very highest bids. If a bid is so high that it seems implausible as a genuine result of careful analysis, the more likely explanation is free riding, and thus we look for excessively high bids in our data. In four of our twenty auctions, the highest bids were more than 1,000% of the reservation price. The highest bid was 1,153% (817%) of the reservation price (clearing price) for STIC, 1,200% (1,182%) for Eng Wah, 1,700% (1,000%) for Hwa Tat Lee Holdings and 5,000% (2,778%) for Singapore Telecom. In the case of Singapore Telecom, the reservation price of \$2.00 translated to a prospective price-earnings (PE) multiple of 27 times. The highest bid was 50 times this, implying a PE of 1,350 times for a mature company in an established industry. This is clear evidence of the presence of at least some free riders, while our earlier analysis indicates that there were sufficient numbers of such investors to affect the auction price.

<sup>49</sup>For IPO auctions in Taiwan, Chiang et al. (2009a) find that institutional investors are informed and bidding optimally, but that retail investors are return-chasing and following suboptimal bidding strategies. Chiang et al. (2009b) find further evidence that retail (but not institutional) investors in Taiwan’s IPO auctions suffer from naive reinforcement learning, while DeGeorge et al. (Forthcoming) find evidence of free riding and possible return-chasing by retail investors in U.S. IPO auctions.

<sup>50</sup>Since two auctions were undersubscribed, we are not able to estimate the bid distribution shape there. However we note that both of these auctions produced positive returns (48.3% in case of Sunright and 6.4% for LiangHuat Aluminum), and their undersubscription implies either a low  $\mu$ , or low  $\sigma$ , or both, so we consider our results to be conservative

**Figure 10: Applications Distribution and IPO Returns**

Returns are market-adjusted (using STIC index); 1 year from tender. Circle area proportional to absolute return; red filled circles represent losses; blue crossed circles represent gains.



**Table 4: Applications Distribution and IPO Returns**

Regressions of gross returns to investors who get in and out of a position at different points in time on estimated parameters of the distribution of bids in the IPO auction. Returns are between the points listed, which are (FIX: fixed price tranche, AUC: auction clearing price, 1D: first trading day close, 1Y: last close in the first year of trading), market-adjusted where relevant: e.g. (FIX, AUC) is the auction premium, and (1D, 1Y) is the market-adjusted return from the first day to the first year close.  $\sigma$  and  $\mu$  are the estimated parameters of the fitted lognormal distribution. Panel A shows results from a regular least squares regression (robust variance estimates are used). Panel B reports coefficients from robust regressions that reduce the impact of outliers (see Hamilton (1992) for a detailed description).

	(FIX, AUC)	(FIX, 1D)	(FIX, 1Y)	(AUC, 1D)	(AUC, 1Y)	(1D, 1Y)
Panel A: Least Squares Estimates						
$\hat{\sigma}_N$	-0.536 (-0.76)	-0.270 (-0.25)	-3.289** (-2.60)	0.171 (0.32)	-2.179** (-2.62)	-2.285** (-2.86)
$\hat{\mu}_N$	1.269*** (14.85)	1.237*** (7.93)	0.385* (1.77)	-0.0129 (-0.10)	-0.486** (-2.48)	-0.451** (-2.65)
Constant	0.0145 (0.13)	0.0136 (0.08)	0.715** (2.67)	0.000676 (0.01)	0.509** (2.80)	0.495*** (3.27)
R <sup>2</sup>	0.866	0.721	0.298	0.006	0.502	0.571
Obs.	18	18	18	18	18	18
Panel B: Robust Estimates						
$\hat{\sigma}_N$	-0.478 (-0.72)	-0.129 (-0.12)	-3.077* (-2.08)	0.123 (0.16)	-2.088** (-2.19)	-2.244** (-2.32)
$\hat{\mu}_N$	1.271*** (8.51)	1.226*** (5.17)	0.435 (1.31)	-0.00493 (-0.03)	-0.385* (-1.80)	-0.438* (-2.03)
Constant	0.00306 (0.03)	-0.00910 (-0.05)	0.639** (2.51)	-0.00856 (-0.07)	0.433** (2.65)	0.480** (2.90)
R <sup>2</sup>	0.841	0.670	0.237	0.002	0.458	0.501
Obs.	18	18	18	18	18	18

*t* statistics in parentheses

\*  $p < 0.10$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$

### 5.3. Lessons from Treasury Auctions

The auction method is old and well established, and has been particularly successful for the largest security issue markets – those for government debt, particularly US Treasury securities. Auctions have been frequently used for new preferred stock issues in the United Kingdom, particularly for government-owned utilities<sup>51</sup>. Key differences between government debt and IPOs make auctions theoretically more likely to work for these high grade debt auctions. First, Treasury auctions are held frequently at regular time intervals, with a core of regular participants. Fleming (2007) shows that, for 903 US Treasury security auctions between July 30, 2001 and December 28, 2005, 75.4% of the securities were purchased by dealers and brokers. Although there are more than 800 financial institutions set up to bid directly in Treasury auctions, they accounted for only 0.5% of the allocations, with individuals accounting for another 0.5%. Thus, Treasury auctions have a stable set of regular bidders – the 22 primary dealers that are expected to participate regularly. Moreover, close substitutes to the extremely high grade debt securities being issued are already trading actively in the market (on the when issued market, through the off the run securities, etc.), making valuation relatively easy and precise.

In spite of these advantages it took several decades for auctions to replace the fixed price method for selling Treasury bonds, even after auctions had been adopted for US Treasury bills. Garbade (2004) provides a detailed analysis of this process, noting in particular how back in 1959 the Secretary of the Treasury Robert Anderson in his testimony before the Joint Economic Committee defended the fixed price method, stating that “many of the small banks, corporations, and individuals... did not have the professional capacity to bid in an auction. Lacking professional expertise, they were liable to either bid too high and pay too much or bid too low and be shut out, and therefore were likely to avoid note and bond auctions altogether”. Garbade (2004) further demonstrates that these worries were quite well-founded, given that the US Treasury failed in its first two attempts, in 1935 and 1963, to establish auctions for long term bond sales. The third attempt, in the early 1970s, succeeded due to the Treasury’s combined “familiarity, gradualism, and willingness to improvise”.

Fleming and Garbade (2002, Table 2) show that even now, of the four main securities lending facilities in the US and UK, two of the four use fixed price public offers rather than auctions. One reason for this can be that bidding is difficult even for today’s sophisticated institutional investors. For example, Fleming and Garbade (2007) offer evidence that dealers frequently fail to shave their bids sufficiently in certain types of US Treasury auctions, passing up “true arbitrage opportunities” in these auctions. Fleming et al. (2005) show that they also fail to exploit certain simple mechanical profit opportunities<sup>52</sup>. On the other hand, Goldreich (2007) shows that both discriminatory and uniform price Treasury auctions lead to underpricing. Thus, even in cases when some of the easiest-to-value securities are sold to a regular set of sophisticated investors, there is evidence that the auction method has not always been preferred over fixed price methods, and that these regular bidders sometimes lack the sophistication to place optimal bids. In contrast, IPOs occur less frequently, at sporadic intervals, and their value is much more difficult to determine. Each issue is different and may attract a different set of participants, many of whom have little relevant experience. Thus, the apparent relative success of contemporary auctions for government debt does not guarantee that the auction method will also be preferred for IPOs.

As we can see, even in Treasury auctions, it took a while to make things work. The key feature is the stable number of sophisticated bidders, coupled with a noncompetitive tranche to accommodate unsophisticated bidders.

## 6. Conclusion

In this paper, we first established a surprising empirical regularity - that IPO auctions have been tried in at least 25 countries, and have generally been rejected in favor of other methods for bringing new equity issues to the market. IPO auctions have been used for issues of all sizes, from very small to very large. The auction methods used have varied, yet the outcomes have been surprisingly consistent: When issuers have been given a choice, they have generally chosen not to use auctions once they became familiar with the method. In this sense, IPO auctions have consistently failed the market test.

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<sup>51</sup>In the six month period from Oct. 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.

<sup>52</sup>Due to the specific price rounding scheme used in Treasury bill auctions, some bids offer strictly inferior expected profits; however many participants still bid at those suboptimal levels



We did not find support for the common explanations offered for the unpopularity of IPO auctions in the US - that issuers were reluctant to use a new, experimental method, or that underwriters pressured issuers to use a method for which they charged higher fees or were able to allocate underpriced shares. We did not find that issuers consistently preferred the method that led to the lowest initial returns. Moreover, there is little support for the popular view that auctions lead to highly accurate pricing and hence to a low mean and variance of initial returns.

In order to explain these regularities, we examine the issue of complexity. While indirect mechanisms, such as auctions, may have simple rules, this does not imply that the investors' task is in any way simple: for example, bidders must place their bids before knowing how many others will enter the auction, and those who invest time and money evaluating an offering risk being squeezed out by others who do not adequately understand the optimal bidding strategies and perhaps have no information on the value of the shares.

The optimal bid for any one participant depends on the number of other bidders, their information sets and their bidding strategies, but none of this is known at the time that bids are placed in a sealed bid auction – presenting a structural risk, which can easily exceed the uncertainty about valuation of the company itself. In other words, optimal auction bidding strategies are complicated, requiring sophistication and discipline, and mistakes by some impose costs on all bidders. Without some way to screen out “free riders” and ensure the participation of sophisticated, long term investors, IPO auctions are highly risky for both issuers and bidders.

Book building, on the other hand, requires less bidder sophistication. With book building the underwriter can act as a gatekeeper, coordinating the number and type of entrants, and setting the price and allocations only after observing all orders. At the same time, book building gives enormous discretion to the mechanism administrator (i.e. underwriter), whereas auctions are transparent with little discretion. Book building is thus vulnerable to abuse by underwriters, at the expense of issuers. [Jagannathan and Sherman \(2005\)](#) propose ways to make book building more transparent and thus, effectively, closer to auctions in that sense. The optimal placement method is likely to be different from both traditional book builds, with their lack of transparency and resulting opportunities for potential abuse, and standard sealed bid auctions, with their high risk for both investors and issuers.

Standard sealed bid auctions have rigid, automatic pricing and allocation rules that do not appear to satisfy the many goals that issuers have for IPOs, based on the market test. However this does not mean that optimal auctions – or more generally, transparent placement methods – cannot be designed. One simple change which might improve auction outcomes is to use hybrids, with retail investors allowed to participate only in the fixed price public offer tranche. This is a somewhat crude but simple and cheap way to try to limit auction participants to a relatively small, predictable number of sophisticated bidders. Retail investors would still be able to participate in hybrid IPOs through the retail tranche, but they would not be able to disrupt the price-setting process.

Although the outcomes in various countries have been surprisingly consistent in terms of which issue methods have been chosen by issuers, it is important to offer a menu of alternatives to issuers, since the best method may depend on conditions and may change over time. For example, uniform price auctions may be a better method in exuberant times, when accurate evaluation is difficult and thus not the main driver of pricing, such as with dot.coms during the internet bubble. At that time dot.com stock valuations were probably driven mostly by animal spirits. The use of uniform price auctions would have allowed the offer prices to be driven up until the shares were overpriced by most estimations, leading to aftermarket price drops that would have popped the bubble earlier. Since each issue method has advantages and neither clearly dominates, only the market can tell whether there is a place for both or only one of them. Having competing mechanisms available to issuers at any given point in time will be to the advantage of investors as well as issuing firms.

In summary, there have been many experiments with IPO auctions across different countries, cultures and market conditions over the last several decades. However, auctions have failed to capture sufficient market share. We offer an explanation for this, based on the complexity of optimal bidding strategies and the vulnerability of each bidder to mistakes by others. Suitably designed auctions that overcome these limitations may well be preferred over book building for bringing new equity issues to the market in the future.

## **Appendix A. Baseline Auction Model**

Consider a simple uniform-price auction: There are  $K$  lots of IPO shares offered for sale. Each lot consists of  $n$  shares, where all shares have the same random, ex ante unknown value of  $V$  to everyone, with a common knowledge

prior  $G(V)$ , with  $EV < \infty$ , which is assumed to have a positive density everywhere on a compact support  $\Omega_V \subseteq \mathbb{R}^+$ . There are  $N$  identical bidders who compete for the allocations. Utility of a bidder who receives an allocation of  $x$  shares at a price  $p$  is given by  $u(c_0 + (V - p)x)$ , where  $u$  is a strictly increasing, concave function, and  $c_0$  is his initial capital. Without loss of generality, we normalize  $u(c_0) = 0$ . The expected value of shares and expected utility are both assumed to be finite:  $EV < \infty$ ,  $Eu(c_0 + (V - p)x) < \infty \forall p \in \Omega_V, 0 \leq x \leq 1$ .

For expositional convenience we consider a unit-demand auction, where all  $K = 15$  winning bidders receive identical allocations of one lot of shares each, and all  $N - K$  losing bidders receive an allocation of 0.

We first consider the case with zero information and transaction costs. Every bidder  $i$ ,  $i = 1 \dots N$  receives conditionally independent, identically distributed signals  $s_i$  about the true value  $V$ :

$$s_i \sim F(s_i|V) \tag{A.1}$$

where  $F(s_i|V)$  is assumed to have a finite expectation and a strictly positive density over a compact support  $\Omega$ . Without loss of generality, we impose a normalization  $Es_i = V$ .

After observing their signals  $s_i$ , the agents submit their bids  $b_i$  for one lot each. The agents' strategy (or *bidding function*)  $B(s)$  is the correspondence between their signals and bids:  $b_i = B_i(s_i)$ .

The auctioneer collects bids  $b = \{b_1 \dots b_N\}$ , determines the clearing price and allocates one (and only one) lot of shares to every bidder whose bid is above the clearing price. An allocation without preferences and rationing implies that the auction clearing price  $p \in [b^{(K+1)}, b^{(K)}]$  – i.e.  $p$  lies between the bids of  $K$ 'th and  $(K + 1)$ 'st agents<sup>53</sup>. For the sake of argument, let  $p = b^{(K+1)}$ . Ties are broken at random (note that when the unconditional signal distribution has no mass points and all bidders' strategies are strictly increasing in their signals, a tie is a probability zero event).

An equilibrium allocation is such that for each bidder  $i$  his strategy  $B_i$  is the optimal response to the collection of other bidders' strategies.

This model, under assumptions of symmetry<sup>54</sup>, full rationality, identical priors and common knowledge of the information structure, is analyzed in Milgrom (1981). It is useful to repeat some of the results from there, and to demonstrate their quantitative implications.

**Theorem 1.** *The above model has a unique symmetric equilibrium, where every bidder  $i$  has the same, strictly increasing bidding function  $B(s)$ , that solves the equation*

$$E\{u(V - B(s)) | S_i = s, s_{-i}^{(K)} = s\} \equiv 0 \tag{A.2}$$

and in the risk-neutral case  $u(x) = x$  take a simple form of

$$B(s) = E\{V | s_i = s, s_{-i}^{(K)} = s\} \tag{A.3}$$

where  $s_{-i}^{(K)}$  is the  $K$ 'th highest signal of all agents other than  $i$ .

PROOF. See Milgrom (1981).

In other words, agents can't do better than bid under the assumption that they have received the *lowest* of the winning signals. Note also that monotonicity of  $B$  also implies that  $B$  is strictly positive everywhere in the interior of  $\Omega$ : in other words all  $N$  bidders submit bids in equilibrium.

As the number of bidders increases, the auction price asymptotically approaches the true value  $V$ , in other words, the auction discount approaches zero (see Pesendorfer and Swinkels (1997) for a detailed analysis and a discussion of the relevant assumptions).

In the numerical examples we examine, unless otherwise mentioned, we consider a hypothetical IPO with an ex ante expected value of \$15 million, split into  $K = 15$  blocks of 100,000 shares each, where the share value  $V$  has a lognormal distribution with  $E(V) = \$10$ , and standard deviation of  $\log(V) = 0.30$  (i.e. corresponding to a standard

<sup>53</sup>Here and below, we use notation  $z^{(K)}$  to denote  $K$ 'th highest component of a vector  $z$ , and  $z_{-i}$  to denote a vector with  $i$ 'th component dropped:  $z_{-i} = \{z_1, z_2, \dots, z_{i-1}, z_{i+1}, \dots, z_N\}$

<sup>54</sup>Here meaning that the bidding functions of different participants are the same:  $B_i(\cdot) \equiv B(\cdot) \forall i$

deviation of 30% for the continuously compounded rate of return to an uninformed investor in the stock). The private signal  $s_i$  is centered at the actual share value, conditional on which it is also lognormal with a standard deviation of 30%. The bidder pool consists of  $N$  potentially informed bidders. In addition to the risk-neutral case, in order to investigate the effects of bidders' risk aversion, we will also consider constant relative risk aversion bidder utility  $u(c) = \frac{c^{1-A}}{1-A}$ , with initial capital of  $c_0$  calibrated to \$30 million for each bidder.

## Appendix B. Evaluating Auctions

To find equilibrium bidding functions in the calibration exercises, we numerically solved equation (A.2) in the symmetric case, and its suitably adjusted modifications in the other cases. The lognormal signal distribution was approximated with a truncated lognormal on a range  $[\underline{S}, \bar{S}] = [e^{\mu-10\sigma}, e^{\mu+10\sigma}]$ . Monte-Carlo integration with 100,000 draws of  $(V, s_{-i})$  was used to compute the conditional expectations; in order to properly account for low tail probabilities and avoid underflow we used importance sampling<sup>55</sup>. In risk-neutral cases such as (A.3) the optimal bids were computed directly; in the general case, a two-step procedure was used: in the first step, a Monte-Carlo sample was generated; in the second, an iterative zero-finding algorithm<sup>56</sup> was used to find the optimal bidding function conditional on the sample. We found that the solution is very robust with respect to the Monte-Carlo sample selection.

In order to improve computational performance, integration was used to evaluate the bidding functions on a grid of values spanning  $[\underline{S}, \bar{S}]$ , with piecewise cubic Hermite polynomials<sup>57</sup> used to interpolate the functions between the grid points.

Given bidding functions computed as above, various outcomes such as expected profits were also computed using Monte-Carlo simulation with 1,000,000 iterations.

## Appendix C. Details on International IPO Experience

### Appendix C.1. High first day gains

- Tenaga Nasional, Malaysia, May 1992, 34%: Malaysia's first auction was a hybrid discriminatory auction/public offer. Initial returns for winning bids ranged from 23% to 34%, even though the market-clearing price in the auction was almost 46% above the 4.50 ringgit reservation price. The initial return for the public offer was 94%.
- DDI (an affiliate of Kyocera), Japan, September 1993, 49%: Bids went as high as ¥6.02 million/share. The offer price was set at ¥3.7 million, because most successful bids were concentrated at that price. The first day's close was at ¥5.5 million.
- East Japan Railway, Japan, October 1993, 58%: JR East soared 70% above the market-clearing price the first day, only to drop back down to around the ¥370,000/share offer price within two days. Winning bids ranged from ¥352,000 to ¥623,000, so the highest bidders were still out of the money when the stock closed at ¥600,000 the first day.
- Petron, the Philippines, Sept. 1994, 63%: Hybrid discriminatory auction/public offer. The first day's closing price was 63% above the lowest winning bid, 23% above even the highest bid, 39% above the highest foreign bid and 136% above the reservation price. The fixed price tranche drew 459,133 subscribers.
- Andover.net, US, December, 1999, 252.1%: The offering was priced at \$18 even though the clearing price was \$24, reportedly to avoid any delay. The first day's closing price was 164% above even the auction clearing price.
- El Al, Israel, June 2003, 40%: Demand was low in the auction – they sold fewer shares than expected, all priced at the minimum bid. The shares began trading on the Tel Aviv Stock Exchange just two days later, closing up 40% the first day and up a total of 112% by the end of the second trading day.

<sup>55</sup>See, for example, Judd (1998).

<sup>56</sup>See Forsythe et al. (1977)

<sup>57</sup>Selected to ensure monotonicity of the interpolating function, see Fritsch and Carlson (1980)

*Appendix C.2. High first day losses*

- Japan Telecom, September 1994, down 14.5% from the weighted average bid price of ¥5.44 million/share on the first day, and down another 10% by the end of the week: The lowest successful bid was ¥5.22 million, but the public offer price (set after the auction) was ¥4.7 million, showing that the auction bids were considered unrealistic. The weighted average bid price gave the company a P/E of 219 times prospective earnings, in a mature telecom market.
- Japan Tobacco, October 1994, down 23.5% the first day, and it kept falling from there: The auction had been unusually enthusiastic, with a weighted average winning bid of ¥1.438 million/share for shares that institutional investors valued at no more than ¥800,000. Successful bids ranged from ¥1.362 million to ¥2.11 million. It closed the first day at ¥1.10 million, and the second day at ¥1.06 million (down more than 26%). After 2 weeks of trading, it was at ¥956,000, down 33.5%. The highest bidders lost almost 48% the first day. 41% of the shares were never sold.
- Global Securities (Global Menkul Degerler A.S.), Turkey, May 1995, down 11% the first hour: The reservation price was set at TL6,000 per share, but bids went as high as TL100,000. The auction price was set at TL9,750, a 62.5% premium. The price fell by 56.1% (giving a market-adjusted return of -60.5%) over the first three months.

Country	Argentina	Australia	Austria	Bangladesh	Barbados
Main sources:	E-mail - COMISIÁN NACIONAL DE VALORES (ciprod@mecon.ar) 1/29/99; ^The Economist Intelligence Unit; ~"Black gold" by Katherine Conradt, <u>LatinFinance</u> 07/01/1993	Euroweek April 1998 Supplement; Australia: A Special Report; ^Letter - Australian Stock Exchange, 23 April 1996	Letter - Wiener Borse (Vienna Stock Exchange), 14 June 1996	Press Release, Chittagong Stock Exchange, Sept. 14, 2008	Letter - Securities Exchange of Barbados, 8/28/97
Does gov't restrict method?	No	No	No	Yes	
Most common method	^Hybrid Book Building	Hybrid Book Building	Hybrid Book Building	Public Offer (only method allowed until recently)	Public Offer
* Public offer (Fixed price)		Have virtually disappeared	Yes - Usually for small firms	Yes	Yes - only method used
Advance payment?		^Yes	No		Yes
* Book Building	Yes	Yes - "the norm"	Yes - Traditional for large IPOs, such as privatizations		
Is it gaining popularity?		Already dominant	Yes		
When was it first used?	~1993 for Yacimientos Petroliferos Fiscales	1992			
* Tender/Auction	~Tried in 1991-92, then abandoned	Tried briefly in 1999 (see below)	No	Allowed, beginning 2009	
Discriminatory/uniform					
Hybrid Methods?	Yes, at least for privatizations - Hybrid Book Building/Public Offer	Yes - "open priced book building approach" widespread	Yes - book building for larger issues includes an open pricing public offer tranche	Yes - auction with fixed price public offer	
General notes:	^According to the Economist Intelligence Unit, March 9, 2000, listings on the Buenos Aires Stock Exchange have been declining for years. ~In 1992, a Dutch auction was used for the Telecom privatization, but the overpricing led to a market crash. So, in 1993 for Yacimientos Petroliferos Fiscales, book building was used for the first time, with great success.	Two offerings by Ord Minnet's eCapital in 1999 were called bookbuilds but were online auctions, with updated weighted average bid prices posted twice a day and people allowed to change their bids any time during the auction. The open priced bookbuilding approach was pioneered in Australia by the then Potter Warburg in the 1992 Government Insurance Offices flotation. "Short form" retail prospectus first used in Nov. 1998. According to Asian Business, Sep. 2000, "Enter e-IPOs", scrippless "e-IPO" methods already in use.	Public offer procedures are different from listing offer procedures & are governed by different EU directives. IPOs are possible without listing. Subscription periods vary widely - up to seven weeks for smaller IPOs; 2 - 3 days for internationally announced, well-publicized offerings, with a possibility of early closing; occasionally, privatizations close only after a few hours. It is possible that the foreign tranches of some large IPOs have included auction-type elements	In 2009, Bangladesh began allowing two stage sequential hybrid offerings where prices are set through the "true Dutch auction" method. Only institutional investors are allowed to bid in the auction. The subsequent fixed price public offer opens at least 25 days after the auction price is determined. This method is officially called "book building", but the offer price is automatically set at the market-clearing price and allocations are pro-rata.	There were 3 IPOs in 1994, none in 1995 and 2 in 1996. 1994: Barbados Farms Ltd., ST. James Beach Hotels Ltd. and CIBC W.I. Holdings Ltd.; 1996: Almond Beach Resorts Inc. and Life of Barbados Ltd.

Country	Brazil	Canada	Chile	China
Main sources:	E-mail, COMISSÃO DE VALORES MOBILIÁRIOS, <intl@cvm.gov.br>, 9/20/99; ^www.bndes.gov.br.; ~Letter - Bolsa Do Rio, 26 Aug. 1996; *Newspaper articles	E-mail, Commission des valeurs mobilières du Québec, 10/29/99	E-mail, Superintendencia de Valores y Seguros, Oct 7, 1999; ^ Santiago Stock Exchange, 11/14/99; *Celis and Maturana(1998).	Gao (2010); *Newspaper articles
Does gov't restrict method?	No	Yes	No (but pension funds can only buy thru an exchange)	Yes - Only one method allowed at a time; changed often
Most common method	Hybrid Book Building	Book Building	*Hybrid Book Building/Auction on Exchange	Public Offer
* Public offer (Fixed price)	Yes, ~but usually with IB discretion in allocation	Sometimes, only in combination with bb	Allowed	Used in early 1990s
Advance payment?	Yes; some term pmts	No		Yes
* Book Building	Yes - first used in global offers; now also in domestic offers.	Yes - primary method	Yes	Yes, but with very unusual features; market still developing
Is it gaining popularity?	Yes		Yes	
When was it first used?	1992, for global offerings		*1995	2005 for local offerings (earlier for foreign portions of international offerings)
* Tender/Auction	Allowed; *sometimes used before 1994	No	Yes - on stock exchange	Yes, from 1999-2002
Discriminatory/uniform	~Both have been used			Uniform
Hybrid Methods?	Yes - bb with public offer	Sometimes - bb with public offer, but no pay in advance (similar to US bb w/ some shares sold to retail)	Yes - bb to determine price & auction on exchange for pension fund investors	Yes, hybrid bookbuilding/public offer, but with unusual features
General notes:	As in many Latin American markets, there were few domestic IPOs in Brazil for many years, with delistings outnumbering new listings. According to the International Federation of Stock Exchanges Sept. 2000 Newsletter, there was only one IPO in 2000 and only 7 or 8 in the last four years. *In 2000, 41 companies were delisted by November 6, with another 27 expected by year-end. *The market picked up in 2006, with 26 IPOs that year and more than double that number in 2007.	Issuers can specify the price in the preliminary prospectus, making the method more like Public Offer, but they rarely do. Best efforts offerings are legal but also rare.	^,*Regulations changed in 1995 to allow pension funds to buy IPO shares, but only through an exchange. Thus, road shows are used to set price and allocate some shares, while shares to pension funds must be sold thru either an auction or daily transactions on the exchange. Almost all IPOs are best efforts rather than underwritten. Major tax advantages to individuals buying primary shares guarantee them an approximately 10% return per year for 5 years if the stock price doesn't move.	From 1990-2000, strict quotas limited which companies allowed an IPO. Fixed price public offers were used for most of the 1990s, with prices set by government formulas rather than by issuers. The price rule was based on book values from 1990-1995 and required a P/E of 15 from 1996-1999. Auctions were used from July 1, 1999 to 1st half of 2002, with pricing dominated by individual investors through on-line bidding. Offer prices pushed to high levels, with many stocks suffering large losses in later trading. From July 2002 to 2004, the regulator returned to a controlled P/E system, with offering price P/E ratios less than 20. A type of two-stage book-building system was adopted on January 1, 2005. IPO price set by institutional investor feedback, then institutional and individual investors placed orders. *This method was replaced by another form described as bookbuilding in summer, 2009. Bookbuilding methods tried so far in China are not comparable to methods used elsewhere. Regulatory reforms in 1999, 2005 and 2009 all promised to finally reduce the role of the government in price-setting.



Country	Czech Republic	Egypt	Finland	France	Germany
Main sources:	E-mail, the Czech Securities Commission, 10/26/99 ^Prague Stock Exchange Website, www.pse.cz	Newspaper articles in Financial Times, Euromoney, International Herald Tribune, Associated Press Worldstream	E-mail, Financial Supervision Authority of Finland, 11/29/99; ^Letter - Mandatum & Co., 30 May 1996; Also see web page www.rata.bof.fi	E-mail - Listing Division, Paris Bourse SBF SA, 7/28/2000, ^Derrien and Womack (1999)	E-mail - BAWe (Bundesaufsichtsamt für den Wertpapierhandl) 2/2/2000, www.bawe.de; ^E-mail - DGBank, 11/18/99
Does gov't restrict method?	Yes		No	Yes, but many options	No
Most common method	^Hybrid Book Building/Public Offer	Fixed Price Public Offer	Hybrid Book Building/Public Offer	Hybrid Book Building/Public Offer	Book Building
* Public offer (Fixed price)	Yes - "must be used for first round" (for voucher privatizations)	Yes - primary method	Yes	Yes - Offre a Prix Ferme (OPF) or Open Price Offer (OPO; only for hybrids)	Yes - Öffentliches Angebot ^now superseded by bb
Advance payment?	Yes - 30% (installment)	Yes	Usually, for retail investors	No, but need corresponding cash in account	No
* Book Building	^Yes, since 2004	Yes, at least for some large offers	Yes	Yes - Placement Garanti (PG), only as hybrid	Yes - ^"used for almost every IPO"
Is it gaining popularity?			Yes	Yes	Yes
When was it first used?				1993	1995
* Tender/Auction	possible for second round, if number of		Allowed	Rare - Offre a Prix Minimal (OPM)	No
Discriminatory/uniform	"single, but rules of auction can be different"		Uniform price	Uniform price	
Hybrid Methods?	Possible to have auction/public offer, but not common	Yes - bb with public offer	Yes - bb for institutional, public offer for retail at price set by bb - "most common over last 18 months" (to Nov., 1999)	Yes - All book building must be combined with either OPF or OPO	Yes - "lottery" methods often used for retail tranche allocations; IB discretion
General notes:	All Czechoslovakian companies nationalized in 1948 & owned by the state from 1948 - 1990. Two waves of voucher privatizations - in 1993 & 1994. ^Private co. IPOs on Prague Stock Exchange began after Czech Republic entered European Union: Zentiva, 2004; ECM Real Estate & Pegas Nonwovens, 2006; AAA Auto, 2007; New World Resources (NWR), 2008, through a large joint listing in Prague, London and Warsaw. Prague SE less active than Warsaw & Budapest Exchanges. Retail allowed to participate.	The Cairo Stock Exchange was dominated by privatizations for much of the 1990s and saw the first truly private company IPO in 1997, with Cairo Precision Industries. Fixed price public offer with pay in advance was the only method until 2000. Orascom, June 2000, was the first hybrid bookbuild/public offer. After Orascom, there were no IPOs at all until the Dec. 2004 IPO of Lecico, which was also a hybrid bookbuild, as was Egypt Telecom in Dec. 2005.	IPOs governed by Securities Market Act 495/1989. Must set preliminary price range in prospectus. Usually, price for all shares set by bb, but w/ price ceiling for retail tranche (or else retail investors must have at least one day to cancel orders after price set). Investors in public offer sometimes get interest on subscription funds, depending on when subscription was paid. Price for employees usually 10% lower than for retail, for tax reasons. Issuer must at least estimate # of shares for each tranche in prospectus.	Open Price Offer (OPO) introduced in 1999 because sequential hybrid PG/OPF required setting price too far in advance. With hybrid PG/OPO, price is not set until day of listing. *as in hybrid bookbuilds in most countries. Derrien & Womack(2003) showed bookbuild problems due to time delay of PG/OPF. When simultaneous hybrid bookbuilding (PG/OPO) allowed, auctions dried up except for two in 2005: Cafom on Second Marche in January and MG International on Alternext in June. Auctions died out later on unregulated Marche Libre (Free Market).	"In recent time the book building technique has been used for nearly all IPOs, local offers and international offers." ^"Sometimes retail investors are preferred for privatizations or larger transactions. For example, the issuer offers discounts for orders given early within the subscription period." ^A joint statement was made by the larger issuing houses, stating they would not use the auction method.

Country	Hong Kong	Hungary	India	Indonesia	Ireland
Main sources:	General sources; ^Asian Business, Sep. 2000, "Enter e-IPOs"	E-mail, Hungarian Banking & Capital Market Supervision, 11/30/99	SEBI (Securities & Exchange Board of India) web page, www.sebi.gov.in; *Bombay Stock Exchange, 4/13/96; ^Assoc. of Merchant Bankers of India, 5/27/96.	Indonesian Capital Market Supervisory Agency (BAPEPAM) , 9/24/99; www.bapepam.go.id; ^"IBRA sets BCA share price at Rp 1,400", The Jakarta Post, Thurs. 05/11/2000.	E-mail, Irish Stock Exchange, 9/15/ 99; *Newspaper articles
Does gov't restrict method?		No	Yes	Yes	No
Most common method	Public Offer, but Hybrid Book Building/Public Offer increasing	Hybrid Book Building/Public Offer	Auction; was Public Offer		Hybrid Book Building
* Public offer (Fixed price)	Yes	Yes	Yes - *, ^ most common in 1990s	Yes - only method allowed before 2000	Used mainly for larger offerings
Advance payment?	Yes	Yes - minimum 10% installment	* Usually; installments common.	Yes	Yes
* Book Building	Yes	Yes	No - allowed in 1990s, banned in 2005	Introduced in 2000	Yes (traditionally called placing, but the methods are similar)
Is it gaining popularity?	Yes	Yes			
When was it first used?	1994	1994	1999		
* Tender/Auction	Allowed since 1993 but never used	Allowed, not used	Yes, since 2005	No	Very rare.
Discriminatory/uniform			Uniform price		
Hybrid Methods?	Yes - bb only with public offer; simultaneous	Yes - bb/public offer is the most common method	Yes - originally sequential hybrids, which led to timing problems; simultaneous hybrids later allowed	Yes - sequential hybrid, with fixed price public offer after bookbuild	Yes - bb/placing with public offer. Simultaneous.
General notes:	In hybrids, amount initially allocated to retail investors is typically only 10-15%, but clawbacks can raise the % to 30-50% if retail demand high. Often a third, private placement tranche for "strategic investors". Overallotment options common. Grey market trading begins during, or even prior to, the offer period. Substantial interest may be earned on subscription funds when demand is high. ^Hong Kong's Securities and Futures Commission has released detailed guidelines for electronic initial public offerings (e-IPOs).	Greenshoe options common. Current SHs may have right of priority. Otherwise, shares in public offer allocated under "the principle of card dealing, or subscription-proportionate allocation". BB used for the majority of institutional allocations (private placements). Public offer was main method in 1990-94. BB used 1st for large, international transactions. Public offer in hybrids has a fixed price range or maximum price, so final price can be set by bb. Note: Budapest Stock Exchange (as well as Warsaw) most active in region.	BB allowed but heavily restricted in 1995. Rules relaxed July, 1999, & BB became more popular. Sept. 19, 2005, the regulator (SEBI) banned BB in favor of auctions through SEBI Circular # SEBI/CFD/DIL/DIP/16/2005/19/9 changing institutional investor allocations from "discretionary" to "proportionate". Since 2005, only hybrid auctions & pure public offers allowed, but upper limits for auctions make some effectively fixed price also. Auctions may be open book, with updated bidding totals posted online every 30 minutes during auction.	All IPOs fully underwritten; may list on Jakarta or Surabaya Stock Exchange, or both. Allocation method: Max. 40% to institutional (pro-rata); rest to retail, favoring small applications (pooling basis everyone gets at least 500 shares and rest pro-rata; if 500 shares each is not feasible, use lottery). ^ Indonesia nationalized many banks that failed as part of the 1998 Asian flu. IBRA (Indonesian Bank Restructuring Agency) began hybrid bookbuilds to sell banks, beginning with Bank Central Asia (BCA) in 2001	Usual time period from day the offering price is set to the day the subscription period begins varies significantly - approx one month but could be less or more. *The number of IPOs on the Irish Stock Exchange has not been high, but generally the method used now is simultaneous hybrid bookbuilding/public offer.

Country	Israel	Italy	Japan	Jordan	Kenya
Main sources:	E-mails - Tel Aviv Stock Exchange, Feb., Sept. and Oct. 1999; *Newspaper articles	E-mail, Borsa Italiana S.p.A. 11/24/99; ^Italian Stock Exchange Commission (CONSOB) web page, www.consob.it	Pettway (1999); ^Institutional Investor, June 2000, "Opening Japan's Capital Markets"; *Newspaper articles	E-mail, Amman Stock Exchange, 24 June, 1997; ^Amman Stock Exchange web page (accessme.com/AFM).	Fax, Capital Markets Authority, 4/3/00; ^"Deals of the Year, 2009", The Banker, May 1, 2009
Does gov't restrict method?	Not since mid-2007		Yes, but several options	Yes	
Most common method	Auctions?	Hybrid Book Building/Public Offer	Hybrid Book Building	Public Offer - only method allowed	Public Offer
* Public offer (Fixed price)	Yes	Yes - only for retail	Yes, but w/ allocation discretion		Yes
Advance payment?	No	No		Yes	Yes
* Book Building	Allowed since mid-2007	Yes - only for institutional	Yes		^Used only once so far, for the foreign tranche of a large offering
Is it gaining popularity?	Too soon to tell	Already the only method used	Yes		
When was it first used?			1997/1998		^2008, for Safaricom
* Tender/Auction	Yes - required for a decade	Not used	Yes		
Discriminatory/uniform	Uniform price, but two stages		Discriminatory		
Hybrid Methods?		bb/public offer - only method in last few years	Yes - auction of 50% of shares; rest sold at or below weighted average winning bid. *Hybrids also for bookbuilding.		Yes - the one bookbuild still used fixed price public offer for local investors
General notes:	Two stage auctions - Institutional auction takes place 24-48 hours before publication of prospectus. Winning inst'l orders included in prospectus. Institutional investors may not withdraw their bids, can only offer HIGHER prices in public auction. Public auction 7 days after prospectus released. * From 1993-2003, fixed price public offers banned, only auctions allowed. Some auctions, some fixed price public offers occurred in 2004-2007. BB first allowed in mid-2007. Few IPOs in 2 years since BB allowed, due to market conditions.	Substantially more funds raised from sale of existing shares than from new shares for primary offers in general (this includes privatizations and seasoned issues); public offer tranche usually close to 40%, but the size of each tranche can be adjusted based on demand. Maximum price for public offer set at least 1 day before the open of the subscription period.	Discriminatory hybrid auctions required beg. 04/01/89: ≤ 50% auctioned, rest sold at weighted average winning bid price. Changes in 1992 required ≥ 50% of shares auctioned, allowed public offer price < weighted average winning bid (due to perceived auction overpricing). 1994 Japan Tobacco IPO auction raised > US\$5.5 billion. Book building only allowed since 1997. Auctions disappeared within one quarter. ^Commercial Code requires par value backed by minimum of Y50,000 in assets, leading to very high per share prices that discourage retail investors.	^Offering price currently set by Issuing Committee at Ministry of Industry and Trade. This will soon change with the introduction of private sector underwriters to the market. The subscription period will be determined in the near future by the new regulations that regulate the new issues that will be issued in accordance with the Companies Law and the Securities Law that was passed on May 15, 1997.	Public Offer method: Investors pay in advance, wait 3 weeks for refunds. Interest on float goes to compensation fund. Price set 10 days before subscription period opens. Those who apply for minimum number of shares usually get them. Allocation is at the issuer's discretion, but figures on intended allocation must be furnished to Capital Market Authority. ^BB tranche was considered for KenGen in 2006 but too controversial. Safaricom, 2008, is only Kenyan IPO with a bookbuilt tranche so far.

Country	Korea	Malaysia	Mexico	Netherlands	New Zealand
Main sources:	E-mail, Korea Securities Research Institute 10/26/99; ^Korea Stock Exchange fax, International Relations, April 13, 1996; *Newspaper articles	E-mail, Kuala Lumpur Stock Exchange (now named Bursa Malaysia), 1996; *Newspaper articles	E-mail, Bolsa Mexicana de Valores (the Mexican Stock Exchange), Sept.& Nov. 1999; www.bmv.com.mx; ^Newspaper articles	E-mail, Stichting Toezicht Effectenverkeer (SECURITIES BOARD OF THE NETHERLANDS), Oct. 1999; ^"KPN's Stock Won't Trade Until Completion of IPO", Wall Street Journal Europe, 05/20/1994	E-mail 10/15/99 - Securities and Exchange Commission of New Zealand; www.gplegislation.co.nz; ^Fax - Cavill White Securities Ltd., 21 May 1996
Does gov't restrict method?	Yes			No	Yes
Most common method	Hybrid Book Building	Hybrid Book Building	Public Offer	Hybrid Book Building	Hybrid Book Building
* Public offer (Fixed price)	Yes, in hybrids; Was only method until 1998	Yes - traditional method	Yes	becoming obsolete	Yes - but brokers have allocational discretion.
Advance payment?	^Yes	Yes		No	Yes; installments getting popular. Legal min. = 10%.
* Book Building	Yes - most common	*Yes - hybrid	^Yes, at least for international tranches	Yes	Yes
Is it gaining popularity?	Yes	*Yes - it has become the main method		Yes	Yes - last few years
When was it first used?	Required beg.1998 for KSE, 1999 for KOSDAQ			"In recent years"	1997
* Tender/Auction	Only if co. not listing on an exchange	Used for several large privatizations;		Allowed	"Not applicable in practice"
Discriminatory/uniform				Discriminatory	Uniform price
Hybrid Methods?	Yes, at least for privatizations	Yes - both hybrid auctions and hybrid bookbuilds; simultaneous	Yes - bb with public offer	Yes - bb with public offer	Yes - bb for institutional, public offer for retail at price set by bb
General notes:	There have been several dozen internet Direct Public Offerings (DPOs), some of which used auctions. Book building is required if the co. wants to list on KSE or KOSDAQ. *Korea until recently required Public Offer, and the gov't set the offer price until 1996. Recent Korea Gas Co. privatization used public offer for retail, max. order 4,000 shares, and bb for institutional, with price set by bb.	Some issuers must provide profit guarantee (through bank guarantee) of at least 90% of forecast earnings for first 2-3 years. Early 1990s: often long lines for subscription forms. Mid-1990s: began publishing forms in newspapers. 30% of IPO shares allocated to bumiputras (until 2009). Securities Commission still reserves right to review price setting. Before 1/1/1996, the SC set price fairly low, leading to high returns and low application success rates (i.e. heavy rationing) for IPOs. *Recent trend (2009) is to attract foreign, particularly Chinese, firms to list in on KLSE.	IPO "has to be opened to all investors" (except foreigners, who face industry-based limits). ^Stock exchange officials considered lowering listing requirements in 2000, to encourage listings. Regulations loosened in 2007, because listings on the BMV had fallen from 200 a decade earlier to only 133, with only 4 IPOs in 2007. Many IPOs were cancelled in 2008, and no companies had even begun the process in the first half of 2009. Given the overall inactivity of the IPO market, we cannot tell if bookbuilding is likely to become popular.	Book building is "almost standard practice nowadays". The involvement of retail investors in IPOs is high. AEX is currently studying rules concerning the distribution of shares. One of the proposed new rules is the duty to disclose the allotment of the offered securities. ^At least in 1994 and before, book building had to be completed and the final price set before the opening of the public offer subscription period. Almost all issuers allowed grey market ("when issued") trading prior to completion of their IPO.	Public Offer method required by Securities Act 1983, but many exceptions have been made. The Securities Commission is allowed to grant exemptions & has used this power on several occasions since 1997 to permit open pricing, including book building. Book building used mainly for institutional tranche of international offerings but also for strictly local offerings. For Public Offer, brokers have discretion in terms of allocation; "public pool" offerings are rare.

Country	Norway	Pakistan	Paraguay	Peru	Portugal
Main sources:	E-mail - Banking, Insurance and Securities Commission of Norway, Sep. 99; ^Letter - Oslo Bors (Oslo Stock Exchange), 14 June 1996	E-mail, Securities and Exchange Commission of Pakistan, 12/01/99; ^web page - Karachi Stock Exchange (Listing regulations), updated 30-05-1993; *Media search	E-mail - Comision Nacional de Valores, Oct 99; the Stock Exchange web page is www.pla.net.py/bvpasa	E-mail - Lima Stock Exchange, 10/20/99	E-mail, Comissão do Mercado de Valores Mobiliários (www.cmvm.pt), 11/11/99; *Newspaper articles.
Does gov't restrict method?	No	Yes	No	No	Used to, but since relaxed
Most common method	Hybrid Book Building	Public Offer - only allowed method	Public Offer (only method used so far)	Hybrid Book Building	Public Offer, often as a hybrid with Book Building
* Public offer (Fixed price)	Yes, but rare except for retail tranche of hybrid	Yes		Yes	Yes - the most common
Advance payment?	No, not usually	Yes	No	Sometimes, but not usually	Yes
* Book Building	Yes -mainly for institutional.	No	Allowed, not used	Yes	Yes, hybrid with public offer tranche
Is it gaining popularity?	Yes			Yes, particularly for institutional inv.	Yes
When was it first used?	increasingly popular over last few years.				^June '95 Portugal Telecom privatization
* Tender/Auction	Yes, but "rarely used"	Only for privatizations to one buyer	Allowed, not used	Yes	"Very rare" now, but used in past
Discriminatory/uniform	Uniform price				Uniform price
Hybrid Methods?	Yes - bb for institutional and public offer for local retail with price set by bb.	No	No	Yes, particularly for privatizations - Book Building/Public Offer	Yes - bb for institutional, public offer for retail
General notes:	No changes in regulations in last 10 years. ^The main reason for the Public Offer tranche is that companies need a certain # of shareholders, holding shares of at least NOK 5 to 10 thousand, to list on the Oslo Stock Exchange. Small investors sometimes get their shares at a discount, and occasionally they are favored in the allocation process.	Offer price was set by the government up to June 30, 1995. ^May refund unused subscription funds through direct deposit rather than mailing check. No company listed unless public offer subscribed by at least 250 applications. Prospectus published at least 7 but no more than 30 days before subscription period begins; share certificates sent to successful orders within 30 days of subscription close.	Only fifty companies quote in the only Stock Exchange, the Bolsa de Valores y Productos de Asuncion S.A. (BVPASA), most having opened their capital only partially. Most shares were placed among existing shareholders in virtue of the right of preferential option. The first stock negotiations in Paraguay took place in October 1993 (market less than 10 years old).	Book building used mainly for international transactions but sometimes for local issues. Most Peruvian companies are closed "family" companies. Therefore raising capital is seldom done through an IPO. Primary Public Offering Regulation, modified on October 12, 1998 considers that primary offers should be carried out through an exchange floor, to provide issues with a more transparent and regulated framework as well as to attract local and foreign investors.	Bookbuilding first used for insttutional tranches of privatizations, but became popular for private company IPOs as well. Auctions popular for IPOs in the 1980s but 'very rare' in the 1990s. *No private Portugese company chose an auction after 1988, but the government still used auctions for privatizations until the insurance company Mundial Confianca's April 1992 tender left 34.6% of shares unsold.

Country	Singapore	South Africa	Spain	Sri Lanka	Sweden
Main sources:	E-mail - Stock Exchange of Singapore, 10/11/99; also the SES web page (www.ses.com.sg)	Web page and e-mail - Johannesburg Stock Exchange, 10/99; www.jse.co.za *Newspaper articles	E-mails, Bolsa de Bilbao 11/16/99; *COMISIÁN NACIONAL DEL MERCADO DE VALORES 9/23/99, 10/18/99; ^Euromoney, Apr.'99, p.99-102	Letter - Colombo Stock Exchange, 26 May, 1997	E-mail, OM Stockholm Exchange, 7/25/2000; ^Letter - Finansinspektionen (the Financial Supervisory Authority), 12/18/1996
Does gov't restrict method?	Yes	Yes	*No	No	No
Most common method	Hybrid Book Building	Hybrid Placing (similar to Book Building)	Hybrid Book Building	Public Offer	Hybrid Book Building
* Public offer (Fixed price)	Yes -traditional	Yes, but not popular except as part of hybrid	Yes - retail tranche	Yes - only commonly used method	Yes
Advance payment?	Yes; sometimes a fixed fee instead	Yes	No; deposits sometimes required	Yes	Yes, usually "a couple of days" before delivery
* Book Building	Yes	Placing - similar to bb in allocations but price set in advance	Yes - institutional & sometimes 100%	Allowed, not widely used	Yes, for institutional tranche
Is it gaining popularity?	Yes		Yes		Yes
When was it first used?	1st - 1995, 2nd - 1999; Officially allowed since March 2000				
* Tender/Auction	Allowed; not used since 1994.	No	*Allowed, "not habitually used"	Allowed, not widely used	Not used
Discriminatory/uniform	Uniform price				
Hybrid Methods?	Yes - simultaneous hybrids for both auctions and bookbuilds	Yes - placing and public offer.	Yes - bb/public offer		Yes - bb/public offer
General notes:	First 2 auctions, in '91, '92, were discriminatory. Fund managers disliked them, suggested single price, which was used from '93 on. 12 of 21 IPOs in '93 and 11 of 33 in '94 were auctions. No auctions since. One bb in '95, 2nd in 1999, a possible third one on the way. Rest of the 20 IPOs in '95, 21 in '96, 37 in '97, 21 in '98, 30 thru Sept. '99 all public offer. Electronic Share Application (ESA) and electronic balloting since 1993. 96% of applications thru ESA in 1996, 99% since.	For placing, 30% of the shares must be offered to the sponsoring broker, who must allocate a reasonable number to other brokers (usually 30% of his allocation). They arrange for private clients or institutions to take up parcels of shares, subject to a fee, to ensure sufficient spread of shareholders. A third method, introduction, is allowed for companies that want to be listed but do not need to raise capital. *Telkom privatization, 2003, was first use of simultaneous (rather than sequential) hybrid, i.e., first open pricing.	More and more public offer orders are becoming binding even before final price is set. Sometimes discounts are offered for orders placed before a certain date. Shifting shares between retail & institutional tranches based on demand must be foreseen in prospectus. ^Most offerings have retail tranches that tend to be heavily oversubscribed; private issues sometimes don't bother to include international institutional investors, because local demand is strong.		Hybrids allow open pricing. However, "as a protective measure for the retail investor, a maximum price must be set in advance. The maximum price is normally set above the indicative price range." Privatizations are rare but are usually large and thus use book building.

Country	Switzerland	Taiwan	Thailand	Turkey	United Kingdom
Main sources:	E-mail - - Switzerland Stock Exchange, 11/24/99; ^Letter - Zurcher Borse (Zurich Stock Exchange), 4 June 1996	E-mail Chinese Securities Association, 11/2/99; ^Chiang, Qian and Sherman (2009)	Letter - Securities and Exchange Commission, 14 May 1996; ^Asiamoney, Nov. 2000, "Ratchaburi brings back sweet Thai memories"	E-mail - Istanbul Stock Exchange (intercrd@imkb.gov.tr), March 1999; Fax, Istanbul Stock Exchange, 17 June 1996	General sources; *Brennan and Franks (1997); ^Levis (1990); ~Chambers (2007)
Does gov't restrict method?	No	Yes	Yes	Yes	Yes, but three options
Most common method	Book Building	Hybrid Book Building	Public Offer ^or Hybrid Book Building/Public Offer	Public Offer	Public Offer (but book building for large, international issues)
* Public offer (Fixed price)	Yes - most common in 1980s	Yes; dominant for many years	Yes - most common	Yes - most common	Yes - most popular
Advance payment?	No	No - only processing fee of NTD30	Yes	^Yes	^Yes
* Book Building	Yes - 1st for large, internat'l IPOs, now for domestic also	Hybrid w/ 50% public offer	Yes - for large IPOs such as privatizations.	Allowed; became popular in the late 1990s; first used in 1997	*Placing - similar in terms of allocation
Is it gaining popularity?	Yes	Yes	^Yes, as market recovers from Asia crisis	No	
When was it first used?	Became popular "in last 4 years" (i.e., since around 1995)	2004			
* Tender/Auction	Allowed - not used in 1990s	Hybrid w/ 50% public offer; previously		Allowed; popular in 1994-1995, then	Allowed, not popular
Discriminatory/uniform		Discriminatory		^Uniform price	Uniform price
Hybrid Methods?	Yes - bb/public offer	Yes - auction or bb with public offer	Yes - book building with public offer; ^price set by bb before open of subscription period	Yes - bb/public offer	Yes, although many bookbuilds do not have a retail tranche
General notes:	Most recent privatization was Swisscom (national telecommunications enterprise) in 1998, which used book building. ^The tender method was used in a few cases, during the boom phase of the late 80's, but with little success	Regulatory restrictions limited use of book building for many years. ^Auctions were popular for several years but were abandoned for fixed price public offers. In 2004, bookbuilding became popular and seems to have replaced fixed price public offers. From 1995-2007, there were: 90 auctions from 1995-2003, with 92% of these from 1996-2000; 156 bookbuilds from 2004-2007; and 755 fixed price public offers from 1995-2006. Multiple bids allowed but total bids < 3% of shares sold. Orders non-binding.	Allotment to company's supporters cannot exceed 10% of total. At least 30% of IPO shares must be allotted to public for subscription, unless allotted portion not fully subscribed. Allotments of top 20 corporate or individual subscribers must be publicly disclosed. ^ Price for hybrids set by book building BEFORE the Public Offer subscription period begins.	Auctions popular for two years: 18 of 24 IPOs in '94 & 7 of 29 in '95 used BB, but none of the 17, 27 or 20 IPOs in '96, '97 or '98 respectively used BB (except perhaps Taç Yatirim Ortakligi A.S., listed w/ IPO date in '95, 1st trading date in '98). The rest of the IPOs in these years were Fixed Price Public Offers except for a few (6 in '95, 3 in '96 and 1 in '98) using Sales on the Exchange. ^Issuer must set binding price margin (range) during registration & inform Capital Markets Board (CMB) about final price (w/in margin) 3 days before IPO.	Auctions had periods of heavy use in 1960s and 1983-84. *Of 69 IPOs from 1986-89, 64 were Public Offer, 4 tender and 1 a hybrid tender/public offer. It's not clear how many placings occurred in this period. ^Before the Big Bang on 27 Oct. 1986, placings were not allowed for issues over GBP 3mn. ~Auctions (i.e., tenders) were used in the UK from 1960 to 1986, but accounted for only 8% of all IPOs in that time, while fixed price public offer was the most popular method in those years.



Country	United States	Vietnam
Main sources:	Prospectuses for specific offerings from the US SEC (Securities and Exchange Commission) Edgar website.	HoChiMinh Stock Exchange (HOSE) website, www.hsx.vn; ^ General media sources
Does gov't restrict method?	No	Yes
Most common method	Book Building	Auction
* Public offer (Fixed price)	No	No
Advance payment?		
* Book Building	Yes	No
Is it gaining popularity?	Already dominant	
When was it first used?		
* Tender/Auction	Yes - 22 IPO auctions from 1999-2009	Yes
Discriminatory/uniform	Uniform price	Discriminatory
Hybrid Methods?	Not yet; the need to reconfirm orders once the final price is set would complicate the process but could be worked out, as it has with auctions	
General notes:	2 main methods, firm commitment (book building) and best efforts. Book building more common, used for larger issues. 22 uniform price IPO auctions so far (1999 to mid-2012). 19 of the auctions used WR Hambrecht's OpenIPO method, while three - Netsuite, Rackspace, and popular search engine company Google - used auctions not lead-managed by WR Hambrecht, with some different features. All auction issuers so far have reserved the right to use a "dirty" auction, but transparency is low in the US, so it is usually not clear in practice whether an issuer chose to set the price below market-clearing. Instinet used a hybrid book building/auction in May, 2001. A unique feature of US auctions lead-managed by WR Hambrecht is that many issuers have reserved the right to relay information on bidding trends to certain investors during bidding, leading to clustering of institutional bids. Such leakage of order information is usually illegal in auctions but is common in book building.	Auctions began in 2005; were "open" (all bidders in the same room) until May, 2007. ^For 1st "silent" (sealed bid) auction for Bao Viet (Vietnam Insurance), May 2007, 30% of bidders forfeited 10% deposits rather than pay remainder for their winning bids, after seeing auction results. Vietcom Bank's Dec. 2007 auction 25% oversubscribed at reserve price but only 90% of shares later paid for. Potential bidders pay deposit a few days before auction, and number is announced. Shares trade only OTC for months before official listing.

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