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QUID PRO QUO AGREEMENTS BETWEEN UNDERWRITERS AND VCS (INTERACTIVE PAPER)

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Principal Topic

While there have been several theories advanced to explain underpricing, more recently there has been an increased focus on the practices of underwriters that can aggravate underpricing. In these examples, researchers use agency theory and information asymmetry theory to explain the occurrence of underpricing. Other researchers have argued that quid pro quo agreements are in place which allows the underwriter to underprice shares. Quid pro quo arguments are based on the understanding that investors, specifically venture capitalists (VCs), accept greater underpricing in order to gain access to “hot IPOs” in the future. In other words, VCs will accept an initial loss on their current investment in exchange for promised access to future wealth. In this paper, we seek to extend the understanding of quid pro quo agreements between underwriters and VCs. We suggest that the VC – underwriter relationship contributes to the establishment of quid pro quo agreements beyond promised access to future wealth and allows for immediate wealth realization in the form of shorter lock up periods. We identify the sources of quid pro quo agreements by considering the timing of increased underpricing on behalf of the underwriter and the establishment of atypical lock up periods on behalf of the VC. More specifically, we hypothesize that there will be greater underpricing and a shorter lockup when the underwriter and the VC have been involved in previous IPOs together. These factors will be impacted by the number of IPOs that the firms have been involved in, as well as the length of time that the relationship has existed.

Method

We test our hypotheses on a sample of new ventures going through the IPO between 1995 and 2009. We identify the previous collaborations between the venture capitalist and underwriter. We also identify the underwriter’s history of underpricing and the average lockup period faced by the venture capitalist. Our dependent variables are the amount of underpricing and the lockup period. OLS regression is used to test the hypotheses.

Results and Implications

We find that quid pro quo agreements do exist and lead to more favorable IPO characteristics for both the VC and the underwriter. Instances of greater underpricing in previous relationships are found to be negatively related to the lockup period that the VC experiences.

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