IPO Syndicates, Private Foreknowledge, and the Economics of Excess Search

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Abstract: We distinguish between discovery information and private foreknowledge in the valuation of initial public offerings of corporate securities. An underwriter gathers discovery information to value and price the issue. The issuing firm relies on this information to make the optimal investment decision. In the absence of syndicate restrictions, the inevitable errors in pricing give outsiders the opportunity to acquire private foreknowledge to effect wealth transfers from the underwriter. Because this activity is costly but has no influence on the issuer’s investment, it reduces the parties’ joint wealth. They therefore have an incentive to organize their arrangements to avoid the associated losses. We show how various features of the syndicate system perform this function, increasing the returns to investment banking and decreasing the cost of capital to issuing firms.

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