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The Economics of IPO Stabilisation, Syndicates and Naked Shorts

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Abstract

Stabilisation is the bidding for and purchase of securities by an underwriter immediately after an offering for the purpose of preventing or retarding a fall in price. Stabilisation is price manipulation, but regulators allow it within strict limits – notably that stabilisation may not occur above the offer price. For legislators and market authorities, a false market is a price worth paying for an orderly market. This paper compares the rationale for regulators' allowing IPO stabilisation with its effects. It finds that stabilisation does have the intended effects, but that underwriters also seem to have other motives to stabilise, including favouring certain aftermarket sellers and enhancing their own reputation and profits. A puzzling aspect of stabilisation is why underwriters create 'naked short' positions which are loss-making to cover when, as is usual, the aftermarket price rises to a premium. We set up a model to show that the lead underwriter may profit from a naked short at the expense of the rest of the syndicate given the way commissions are apportioned between them. We argue that a naked short mitigates the misalignment of interests which stabilisation causes between issuer and lead underwriter, although it does so at the expense of the non-lead underwriters.

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