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How do underwriters trade?

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Sean Foley is a Lecturer at the University of Sydney. His research interests include market misconduct, corporate governance and high frequency trading.

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Underwriters of dividend re-investment plans have a legitimate interest in hedging their exposure by going short. However new evidence from CMCRC researchers finds significant abnormal selling volume in the underwriting broker's channel during the pricing period resulting in a lower issue price.

One way companies often raise capital is by allowing shareholders to re-invest their dividends into newly created shares. This is referred to as a dividend re-investment plan, or DRP. These DRP's allow companies to retain the money they would otherwise have paid out, and is viewed as a capital raising exercise. The price at which these new shares are issued is determined during the pricing period, typically the volume weighted average price in the 10 days after the dividend is paid.

While DRP participation is voluntary, firms wanting to ensure they have sufficient funds can underwrite the dividend. This involves offering new shares to a 3rd party – typically an investment bank – equivalent to the amount of the dividend that is to be paid out. In this way, any shareholder who elects to receive a dividend will have this cash outflow matched by funds received from the sale of new shares to the underwriter.

The research uses broker-level data to examine the trading conducted in all accounts (eg. client and proprietary) of the underwriting broker during the pricing period. The findings indicate accounts of the underwriting broker engage in significant selling only during the pricing period, with between 200%-400% more shares sold in each of the 10 days of the pricing period, when compared to a benchmark period.

This behaviour results in significant downward pressure on the stock price. Across 115 DRP's in the 5 year sample examined the price reduction on average is 5.5%. This reduced average price during the pricing period results in more shares being issued under the DRP at a lower price. This has the effect of diluting existing shareholders to the benefit of those participating in the DRP.

The researchers also examined the behaviour of non-underwriting brokers, and brokers in non-underwritten DRP's around the pricing period as a control, however no abnormal trading patterns were observed, confirming the unusual trading behaviour is confined to the underwriting broker's trading accounts.

The implications of this research are twofold. From an investor perspective, shareholders opting to take up the dividend should exercise caution. From a regulator perspective, flagging trades as principal or agent, as will be required post October 2014, is essential to ensure that any selling pressure during the pricing period is attributable to clients not proprietary order flow.

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