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LAW FIRMS AS REPUTATIONAL INTERMEDIARIES AND THE EFFECT ON US-BOUND FIRST OFFER IPO UNDERPRICING

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Abstract

There is information asymmetry between the investment banks that act as underwriters of a first-issue initial public offering (IPO) from outside the U.S. and the subsequent investors. Accordingly, the issued stock can suffer from "underpricing" and fail to maximize potential proceeds of the IPO. The empirical analysis set forth in this paper finds that law firms can act as reputational intermediaries to provide signals of value. Prestigious law firms that represent investment banks are found to reduce underpricing, while the prestige of the law firms representing the issuer can increase underpricing depending on the nation of domicile for the firms.

Introduction

When stocks are first issued on an exchange, the challenge for the underwriter is to set an initial price that will induce investors to purchase the stock, but not forgo the opportunity to maximize profits. Underwriters set a price that is not so high that investors will choose to purchase the stock, but not lower than what the market is willing to bear. Otherwise "equilibrium underpricing," is achieved and the underwriting banks will not leave money on the table in the IPO (Gilson & Kraakman, 1984). Thus, determining means to minimize this underpricing amount is of critical importance to the investment banks and the firms they underwrite in order to maximize profits.

During an IPO, investors are usually looking for signals of quality like reputational intermediaries, which is a proxy for that of the issuing company. There has been a large body

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of literature that looks at the prestige of the investment bank as a signal of quality. Top-ranked investment banks tend to have a greater influence on pricing than those banks that do not enjoy a comparatively high level of prestige (Krishnan, Ivanov, & Masulis, 2011; Carter & Manaster, 1990). Auditor prestige has also been investigated as a signal of quality (Balvers, McDonald, & Miller, 1988; Weber& Willenborg, 2003).However, the prestige of law firms that represent the issuing firm and the bank managing the IPO has received limited attention beyond a general analysis and with a view more on post issue performance (see e.g., Barondes, Nyce, & Sanger, 2007). In another study involving law firm prestige, Beatty & Welch (1996) did not find a statistically significant relationship of law firm reputation and IPO underpricing.

This paper attempts to shed additional light on the effects of law firm prestige on the underpricing of IPOs. More precisely, the research question is twofold. Do the quality and the prestige of legal counsel for the issuer that is located in the United States, is an international firm, or is a combined effort of U.S. and international law firms have an effect on IPO underpricing? If so, what sort of impact: is it adverse or positive impact and why? These issues are important because they will affect whether managers of issuing firms will be incentivized to select more prestigious legal representation when commencing an IPO in the United States. Investment banks will have a similar interest in that they either explicitly select the legal counsel that is to be engaged in the IPO process or passively accept the choice of law firm made by the IPO Company that they are underwriting. Further, this study will address an important gap in the literature regarding the nationality of the representing law firm on international IPO underpricing.

Research Problem, Objectives and Plan

This paper intends to investigate the first-offer IPOs initiated by international companies in United States exchange. The nationality of the law firm that represents the issuer or the manager (i.e., underwriting investment bank) is specifically taken into consideration.Unlike Beatty and Welchs 1996 study, we find that the inclusion of law firm nationality as well as a separate determination of manager and issuer law firms results in statistically significant relationships of law firm prestige and underpricing.

It is found that the prestige of manager law firms (i.e., those law firms that represent underwriters of IPOs) consistently reduce underpricing regardless of whether the law firms engaged to represent the investment banks are only from one country or from multiple countries. When the proceeds of the transactions are taken into consideration, the influence of high prestige manager law firms further reduces underpricing. Interestingly, the inclusion of high prestige issuer law firms in an IPO transaction will increase underpricing if solely represented by foreign-based law firms.

This paper provides a unique contribution to existing underpricing literature in three ways. Firstly, it tests hypotheses which investigate the relationship of law firms domiciled solely in the United States, foreign nations, or a combination of both U.S. and foreign law firms that represent the issuer or manager on subsequent underpricing of the IPO. Secondly, it evaluates the interaction of investment bank prestige against that of the law firms to determine the moderating effect on underpricing. Finally, it examines whether the proceeds of each IPO transactions further influences this effect.

Theory development and Literature review

Firms that seek to offer shares of stock on the open market have to make several critical decisions as to who will provide services to facilitate the process. An IPO requires an investment bank to underwrite the value of the shares and provide investors with the opportunity to purchase shares so as to provide the firm with assets. Accounting firms are also engaged to ensure the financial oversight of relevant valuations and transactions. In all cases, it is incumbent on all parties to the transaction to ensure that legal and regulatory compliance associated with the stock exchange on which the shares will be listed is followed.Law firms are engaged to provide the necessary legal support to the firm issuing the stock and the investment bank(s) that will underwrite the stock offering.

When investment banks agree to underwrite an IPO, they anticipate a level of profitability that will allow them to induce large investors to provide capital to the issuing firm. The investment bank will take the risk that the stock to be issued will not generate the capital sought by the issuing firm because there may be insufficient interest for financial growth. Conversely, when there is a comparatively higher level of interest in investment, the investment bank (IB) will reap the benefits of higher stock prices that large investors are willing to pay.

Large investors in the IPO shares will then offer these shares to the open market, thus allowing for purchasing opportunities by all other potential investors. The price that the shares are sold at on the market presents a similar challenge to the large investors to that of the issuing firm. Selling the shares at too low of a price will leave potential profits unrealized. Offering the shares at too high of a price will cause outside investors not to purchase the stock, driving the price of the stock down in early trading. A price that is reached at the end of the first day of trading that is lower than the initial offering price will signal potential weaknesses of the issuing firm, since it indicates an overconfidence in the future potential value of the newly-listed firm.

Avoiding a lower closing price than an initial offering price on the first day of trading induces investment banks to set a price that is more likely to be lower than it could have been to maximize profits. The setting of an initial offering price that is lower than the close price of the share on the exchange on the first day of trading is known as underpricing. A large spread between the initial price and the closing price indicates a comparatively a large spread of lost opportunity for profits to the issuing firm and the underwriting investment bank. Accordingly, it is of utmost importance to all parties associated with the offering of a stock on an exchange that underpricing be minimized to the extent possible.

Businesses that are not publicly held do not have the obligation to provide detailed information regarding their business practices, strategy, leadership, and prospects for profitability as those that are listed on stock exchanges. Accordingly, there is an asymmetry of information among potential investors (Haleblian& Finkelstein,1999). According to Beatty & Ritter (1986), market participants can be separated into two distinct groups: those that are informed and those that are uninformed. The investment banks and accounting firms that engage with the issuing firms have access to highly detailed information prior to issuance of an IPO and comprise the “informed” investors. The resulting asymmetry of information has considerable influence on resulting underpricing of the IPO (Cohen & Dean, 2005). On balance, outside investors do not enjoy this opportunity to review the financial prospects of the firm and remain relatively uniformed.

The reputation of the parties to the transaction provides key signals to the soundness of the issuing firm. Investment banks that are ranked highest in the industry demonstrate a level of confidence in the offering as compared to smaller or relatively unknown firms (Carter, Dark & Singh, 1998; Carter &

Manaster, 1990; Certo, 2003; Gulati, & Higgins, 2003; Krishnan, Ivanov,& Masulis; Loureiro, 2010; Megginson & Weiss, 1991; Titman and Trueman, 1986). Investors are logically able to discern that a well-established investment bank would undertake the effort and risk associated with bringing an issuing firm to market if it was sufficiently certain that the issuing firm was of high quality (Hambrick, & Pollock, 2008).

For each party of the IPO process, legal counsel is closely intertwined with all transactions. The issuing firm must comply with all of the legal and regulatory requirements of an IPO. These requirements include proper filing of necessary documentation for the Securities Exchange Commission (SEC), state incorporation filings, and contractual obligations among all parties. The investment banks must adhere to these legal requirements as well, since their obligations are necessarily intertwined with those of the offering firm. The issuing firm must rely on the capabilities of their legal representation to not only ensure compliance, but also protect its interests in relation to the investment banks and all other outside parties (Krishnan & Masulis, 2011; Schwarcz, 2007). Similarly, investment banks rely on legal counsel to safeguard their interests against competing goals of all other parties.

Developing the research model and Hypotheses

It has been contended that the choice of law firms for all transactions is either directly made by the investment banks (IBs), or is at least subject to passive approval (Balvers, McDonald& Miller, 1988).However, we contend that IBs may not necessarily consider the prestige of these law firms, or how their level of prestige will complement their own status in making the decision to engage their services. Accordingly,

Hypothesis 1: The prestige of one party to an IPO transaction does not influence the prestige on other parties engaged in the process.

Irrespective of how law firms ultimately become connected to the IPO process, the prestige of the firms provide signals to the investment banks in setting an offering price and to investors who will seek to buy the offered shares on U.S. markets. Where there are law firms that are located in only one country, there will be some degree of uncertainty whether the law firms will fully understand the nuances of each issuers originating country. Law firms that are located in the United States may have a high level of expertise in matters relating to domestic stock exchanges, but lack a full understanding of those legal issues associated with foreign countries. Conversely, law firms that are located in countries outside of the United States may not have a level of expertise required for compliance with US exchanges. These foreign firms may therefore engender a degree of risk that is equivalent to that of US firms in that there may be deficiencies in capabilities.

Further, the issuer firms are engaged to zealously represent the financial interests of the issuer, and may therefore act in a manner that is detrimental to the IBs. Coupled with the potential for reduced expertise, this possibility exacerbates the level of risk inherent in a transaction. Due to this uncertainty, IBs may be inclined to set an issuing price that is lower than is required to generate sufficient interest in the IPO by investors. An alternative reason for potential underpricing is that investors may subscribe a greater level of confidence in those issuing law firms that are representing IPO companies from the same region as the investors. For example, investors may interpret the choice of a law firm from the United States as a signal of value because the issuer would not be able to attract a prestigious firm if it was not a good investment opportunity. By over-allocating value to issuers stock, higher stock prices than were anticipated by IBs result in underpricing. With larger transactions that are anticipated to generate a comparatively higher level of investment proceeds, the exposure to potential loss by IBs will be higher as well. To mitigate risk, the IBs may set a price that is relatively lower than would be set in a comparatively lower investment. Thus,

Hypothesis 2: The prestige of issuer law firms that are located in only one country (i.e., either the United States OR foreign nations) will increase underpricing of IPOs, and larger anticipated proceeds will further increase this effect.

Firms that have multiple law firms involved in a transaction will increase uncertainty, since it will not necessarily be apparent whether the complementary relationshipwith greater potential for proceeds in the IPO increases the benefits of collaboration by prestigious firms. Therefore,

Hypothesis 3: The prestige of U.S. law firms and Foreign law firms (i.e., mixed) that both represent the issuer will increase underpricing of IPOs, and larger anticipated proceeds will further increase this effect.

In all cases, the manager law firms will have a much closer relationship with the IB than that of the issuer law firm. Manager law firms have the role of seeking to promote the best interests of their IB clients and ensure compliance to insulate them from potential liability. Since the IBs will select the firms with whom they engage, they are able to more accurately determine the expertise of these law firms. Since there is less asymmetry of information as to competence, there is a lower risk to the IBs associated with uncertainty.

Higher prestige manager law firms will decrease the information asymmetry that the IB will have in setting the IPO initial price. Accordingly, a price that is more closely related to that which future investors will pay can be set. This will be the case regardless of whether the law firms are solely from the United States, countries outside of the US, or are a mix of law firms from multiple countries.

Hypothesis 4: The prestige of law firms that represent the manager IB, irrespective of country of origin, will have a net decrease in underpricing of IPOs, and larger anticipated proceeds will further increase this effect.

The prestige of IBs affects underpricing in a way such that as the prestige of IBs increases, the degree of underpricing decreases. Therefore, IBs that take into consideration their own prestige relative to other IBs with similar business capabilities will have an interactive effect on underpricing. IBs that have a greater market share of IPOs are more likely to have experience in managing the risks associated with underwriting first-issue foreign offerings on US exchanges. As such, IBs will have the potential to incorporate their knowledge of these IPO transactions in setting a more appropriate offering price that will conform to the investors expectation of value. In addition, highly prestigious IBs have the resources and experience to manage IPOs that have potential for a relatively greater level of proceeds. Moreover, higher anticipated proceeds will encourage IBs to utilize their resources to more extensively investigate the value of IPOs. In so doing, they will have more information to set an appropriate offering price. Accordingly,

Hypothesis 5: The prestige of issuer law firms that are located in only one country (i.e., either in the United States OR foreign nations) will decrease underpricing of IPOs as the prestige of the underwriting investment bank increases, and larger anticipated proceeds will further increase this effect.

Despite the mixed signals associated with multiple firms from different nations, IBs that have more experience in first-issue IPOs are more able to discern whether these multiple law firms are able to pool resources to complement each others capabilities. Hence, *Hypothesis 6:The prestige of U.S. law firms and Foreign law firms (i.e., mixed) that both represent the issuer will increase underpricing of IPOs as the prestige of the underwriting investment bank increases, and larger anticipated proceeds will further increase this effect.*

Higher prestige IBs will have more experience in the benefits of relying on manager law firms, and will use their resources to increase the benefits of this reliance for larger IPO deals. With this combined level of prestige between the manager law firm and IB, underpricing will be reduced. Information asymmetry is at its minimal level with respect to this relationship, regardless of the countries in which the manager law firms are domiciled. Hence,

Hypothesis 7: The prestige of law firms that represent the manager IB, irrespective of country of origin, will have a net decrease in underpricing of IPOs as the prestige of the underwriting investment bank increases, and larger anticipated proceeds will further increase this effect.

Data Used to Test Hypotheses

The data used in this paper were obtained from the Securities Data Corporation (SDC) Global New Issues database. Only those firms that have never issued stock on any exchange throughout the world and initiated IPOs in the United States for their first offering were selected. The time period investigated encompassed IPO between the years 1989 to 2008. Only firms that were domiciled outside of the US but chose to list on the NYSE, NASDAQ, or AMEX were considered. These data included firms located in Canada and Mexico. Closing stock prices on the first day of trading following the IPO on the US exchange were obtained from the SDC database and confirmed using stock price data from the Center for Research in Security Prices (CRSP) and Bloomberg financial information databases.

The law firms that represented the issuer or manager in each IPO transaction were coded as "US", "Foreign", or "Mixed." In preparing the SDC data, "Issuer Lawyer Contact Nation" and "Manager Lawyer Contact Nation" fields were the primary determinant of nationality of the law firms. Law firms were coded as "US" if no foreign firms were listed. The firms were coded as "Foreign" if no US firms were listed. If a US firm was listed as the issuer lawyer, and a foreign firm was listed as manager lawyer (or vice versa), then the law firms were coded as "Mixed." Nationality of law firms was confirmed using the Martindale.com website, which lists country of domicile for virtually all law firms throughout the world.

Further, internet sites for the listed law firms were reviewed to confirm nationality of domicile.

The sole dependent variable for this analysis is the percentage that the IPO was underpriced by the IB. In order to calculate this variable, the price of the IPO stock when issued is subtracted from the price at the close of the first day of trading following the issuing of the IPO stock.

Analysis and Discussion

In order to determine the extent to which the prestige of the issuer law firms, manager law firms, and investment banks are related as set forth in *Hypothesis 1*, we conductedtwo separate tests. First, a simple correlation chart was used to determine the extent to which the prestige measures interrelated with each other. Manager law firm prestige and issuer law firms are correlated at a statistically significant level. However, prestige measures for law firms and IBs do not have statistically significant levels of correlation. This lack of correlation preliminarily suggests that IBs prestige is not necessarily similar to that of law firms.

The correlation table provides some insight, albeit limited, so *Hypothesis 1* was further investigated in an OLS regression analysis. The extent to which the prestige of law firms and investment banks influenced each other were tested each in turn. We controlled for the location of both the issuer and manager law firms in determining the effect of law firm prestige on investment bank prestige. However, this relationship does not have theoretical relevance in the present analysis, since it is unlikely that law firms will have the ability to designate whether IBs will underwrite an IPO. The importance of this relationship, if any, provides opportunity for additional research.

Models (3) and (4) of Table 1 test the influence of IB prestige on that of the law firms involved in the IPO. To avoid redundancy, we did not include dummy variables for the law firms own location to measure law firm prestige, as these would confound the analyses. We did include dummies to control for the location of the complementary law firm in each IPO transaction. The results suggest that the prestige of IBs do influence the prestige of issuer law firms at the $p < 0.05$ level, and marginal significance of the influence on that of manager law firms. Moreover, we discovered an interesting finding of significance of the location of the issuing law firm on the prestige of the managing law firm, and vice versa. This provides an excellent opportunity for future research. Despite the statistically significant result for issuer law firm prestige, the coefficient is less

Table 1
Hypothesis 1

	(1) IBPRSTG	(2) IBPRSTG	(3) ISSLAWPRSTG	(4) MGRLAWPRSTG
ISSLAWPRSTG	0.388 (0.240)			
MGRLAWPRSG		0.108 (0.234)		
IBPRSTG			0.041 (0.020) *	0.029 (0.020)
IL_US	-0.311 (0.292)	0.057 (0.188)		0.169 (0.079) *
IL_FOR	-0.133 (0.273)	0.247 (0.143) +		0.167 (0.058) **
ML_US	0.217 (0.141)	0.093 (0.259)	0.049 (0.057)	
ML_FOR	0.123 (0.150)	-0.006 (0.263)	0.214 (0.060) ***	
ISSYEAR	Yes	Yes	Yes	Yes
REGION	Yes	Yes	Yes	Yes
INDUSTRY	Yes	Yes	Yes	Yes
CONSTANT	0.180 (0.083)*	0.181 (0.084)*	-0.003 (0.036)	0.004 (0.017)
N	505	505	505	505
R^2	0.119	0.114	0.236	0.182
adj. R^2	0.045	0.040	0.176	0.118

Standard errors in parentheses
+ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

Table 2
Hypotheses 2 - 4

	(1) UNDERPRCNT	(2) UNDERPRCNT	(3) UNDERPRCNT	(4) UNDERPRCNT
ISSLAWPRSTG	1.025 (1.482)	0.975 (1.505)	-0.865 (0.723)	-1.368 (0.853)
MGRLAWPRSTG	-2.001 (2.229)	-3.087 (2.354)	-3.891 (1.822) *	-3.969 (1.919) *
MGRLAWPRSQD	42.65 (19.59) *	47.02 (20.20) *	44.47 (19.48) *	46.23 (20.07) *
FIRM_US	0.0585 (0.0600)	0.0609 (0.0608)		
FIRM_FOREIGN	0.0247 (0.0691)	0.0256 (0.0699)		
IL_US	-2.368 (1.647)	-0.859 (2.524)		
IL_FOR	-1.593 (1.509)	-3.214 (1.990)		
ML_US	-1.452 (1.516)	-0.785(1.678)		
ML_FOR	-1.911 (1.561)	-0.763 (1.751)		
FIRM_MIXED			-0.0490 (0.0573)	-0.0573 (0.0580)
IL_MIXED			1.968 (1.457)	6.875 (3.427) *
ML_MIXED			1.745 (1.440)	1.224 (1.615)
IL_ML_PRSTG	12.76 (14.82)	15.18 (15.10)	11.81 (14.46)	17.50 (14.82)
LOGPROCEEDS		0.0122 (0.0176)		0.00905 (0.0173)

Cont. Table 2
Hypotheses 2 - 4

	(1) UNDERPRCNT	(2) UNDERPRCNT	(3) UNDERPRCNT	(4) UNDERPRCNT
IL_PRO		0.0010 (0.0014)		0.0009 (0.0014)
ML_PRO		0.0029 (0.0035)		-0.0017 (0.0015)
ISSYEAR	Yes	Yes	Yes	Yes
REGION	Yes	Yes	Yes	Yes
INDUSTRY	Yes	Yes	Yes	Yes
CONSTANT	0.0695 (0.412)	-0.0277 (0.420)	0.0958 (0.408)	0.0480 (0.414)
N	592	592	592	592
R^2	0.139	0.147	0.137	0.144
adj. R^2	0.069	0.066	0.072	0.071

Standard errors in parentheses
+ $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

than five percent. Accordingly, *Hypothesis 1* is ostensibly supported, since correlation is low and there is a very limited, albeit statistically significant, influence of IB prestige on issuer law firm prestige. *Hypothesis 1* is supported regarding the lack of influence that IBs have on the perceived prestige of manager law firms.

H2 - H4: Testing the extent to which issuer and manager law firm influence underpricing

Multiple models were developed in order to test how issuer law firm prestige and manager law firm prestige affect IPO underpricing. In addition, we tested how the size of the IPO offering influenced the relationships. The models presented include control variables for each year of IPO issue. Further, the originatingnations of the issuing companies were combined into regions: (1) Asia Pacific (including China and Japan), Australia (including New Zealand), and North America (Canada), Caribbean, Europe, and Latin America (including Mexico), and South America. Industry dummies based on the SIC for each issuer company were assigned.

The manner in which the dummy variables were created for the remaining hypotheses disallowed the IL_US, IL_FOR, ML_US and ML_FORto all be included in the same model as that included in the IL_MIXED and ML_MIXED, in that one dummy is required to be dropped as the base. This is why the models necessarily are missing these dummies for Tables 2 and 3. We ran the analyses with all combinations of dummies (i.e., US & Mixed and Foreign & Mixed), as well as each dummy variable separately, and found similar results. Conceptually, we determined that it was preferable to have the US and FOREIGN firms in the same models, and have the MIXED firms in separate models, to maintain the rationale of the differentiation of firm nationality.Regressions excluding controls are available upon request. Interactions that increased the absolute value of corresponding coefficients while increasing the R-squared fit of the model were included.

Squared terms were included in the modelsto determine whether there was a point such that there would be net negative effects of law firm prestige. Intuitively, a highly prestigious law firm could signal a high value of the issuing company. That is, investors could reasonably conclude that the high prestige law firm would not take on low-value clients. However, investors could make an equally rational conclusion that the highly prestigious law firm was engaged because the company has higher levels of risk or other problems that may make it a suboptimal investment. In this analysis, the manager law firm prestige (MGRLAWPRSQD) did exhibit a statistically significant curvilinear effect, and was therefore retained in the model. When we tested for a quadratic effect for the issuer law firm or investment bank prestige, no significance was found, so these terms were not included in the model due to their lack of further explanatory effect.

Again, all terms relating to issuer lawyer prestige do not achieve statistical significance. However, the net effect on underpricing is found to be marginally positive for issuer law firms that are solely domiciled in the US. This suggests that, with the inclusion of variables in the model, Hypothesis 2 would potentially be sustained. In the current model this is not the case, so this hypothesis does not receive statistical support. The same results are found as Model 1, with only the squared term achieving significance. However, the inclusion of proceeds in the model does magnify the effects as predicted. Statistically, Hypothesis 3 is not supported.

With the inclusion of proceeds in the model, it is found that issuer firms that are mixed do increase underpricing, so this hypothesis is supported. Further, it suggests an increase in the underpricing of IPOs, despite the lack of significance for the IL_MIIXED term shown in Model 3.The net result on underpricing is still decreased in this case, but the consideration of the proceeds of the IPO does not demonstrate a particularly large increase on this effect. Regardless, the findings do lend support to this hypothesis. This is

Table 3
Hypotheses 5-7

	(5)	(6)	(7)	(8)
	UNDERPRCNT	**UNDERPRCNT**	**UNDERPRCNT**	**UNDERPRCNT**
ISSLAWPRSTG	1.034 (1.547)	1.051 (1.577)	-1.032 (0.994)	-1.535 (1.117)
MGRLAWPRSTG	-2.963 (2.222)	-3.972 (2.348) +	-5.195 (1.923) **	-5.345 (2.042) **
MGRLAWPRSQD	44.36 (19.97) *	46.36 (20.63) *	46.61 (19.92) *	47.67 (20.62) *
FIRM_US	0.0682 (0.0587)	0.0678 (0.0597)		
FIRM_FOREIGN	0.0113 (0.0701)	0.00838 (0.0708)		
IL_US	-2.536 (1.586)	-0.710 (2.451)		
IL_FOR	-1.434 (1.484)	-3.850 (2.081) +		
ML_US	-1.479 (1.471)	-0.668 (1.626)		
ML_FOR	-2.308 (1.532)	-1.287 (1.733)		
FIRM_MIXED		-0.0559 (0.0564)	-0.0636 (0.0572)	
IL_MIXED		2.069 (1.412)	6.693 (3.336) *	
ML_MIXED		2.030 (1.392)	1.508 (1.564)	
IL_ML_PRSTG	11.42 (21.11)	13.69 (21.47)	12.06 (20.93)	19.26 (21.46)
IBPRSTG	-0.241 (0.332)	-6.501 (10.39)	-0.286 (0.331)	-0.295 (0.333)
IL_U_PRSTG	-6.492 (10.32)	9.925 (8.350)	-4.553 (10.18)	-5.143 (10.27)
ML_U_PRSTG	9.820 (8.271)	131.4 (206.3)	11.34 (8.232)	11.63 (8.307)
LOGPROCEEDS		0.00792 (0.0183)		0.00740 (0.0180)
IL_PRO		0.0009 (0.0015)		0.0009 (0.0015)
ML_PRO		0.0035 (0.0033)		-0.0010 (0.0017)
ISSYEAR	Yes	Yes	Yes	Yes
REGION	Yes	Yes	Yes	Yes
INDUSTRY	Yes	Yes	Yes	Yes
CONSTANT	0.0473 (0.400)	0.0471 (0.407)	0.118 (0.396)	0.0739 (0.401)
N	505	505	505	505
R2	0.172	0.183	0.166	0.173
adj. R2	0.085	0.083	0.084	0.082

Standard errors in parentheses + $p < 0.10$, * $p < 0.05$, ** $p < 0.01$, *** $p < 0.001$

perhaps the most interesting (and unanticipated) finding. When looking at the prestige of the investment banks, issuer law firm prestige for those that are domiciled outside of the US reduces underwriting. Therefore, this hypothesis is not rejected for lack of significance as with previous models. Instead, there is some statistical support that the opposite relationship occurs.The consideration of proceeds does have the net effect of reducing underpricing with a greater magnitude of influence. This suggests that investment banks with higher prestige are more accurate in determining issue price and/or investors are better able to discern the signals presented by these reputational intermediaries.

In an effort to further understand the nature of the curvilinear relationship of manager law firm prestige on underpricing, we took the partial derivative of the regression equations to determine local optimality of law firm prestige. Optimal law firm prestige value was determined by letting y = underpricing and x = manager law firm prestige. The regression equation relating to these two variables is thusy $= a + bx + cx^2$. Through partial differentiation, we getd $y/dx = b + 2cx$. Setting this first order equation equal to zero, and solving for x results in $x = -b/2c$ and provides the local optimum level of prestige.

We used the full model (#6, Table 3) of underpricing analysis, which included location dummies and proceeds variables for the first-order condition differentiation calculation, as recommended in these comments. In that model, $b = -3.972$, and $c = 46.36$, such that the optimum level of prestige that results is 0.043. Using the mixed firm model (#8, Table 3), $b = -5.345$, and $c = 47.67$, resulting in a finding of an optimum level of prestige of 0.056. This is an interesting result, because it adds support to the finding that prestige has an impact on underpricing.

Robustness Checks

The level of prestige may be alternatively indicated by outside evaluation of industry prestige. Investment banks have national rankings that can signal prestige (Carter & Manaster, 1990). In addition, auditing firms may be assigned a level of prestige by being classified in the "big eight" (Balvers, McDonald, & Miller, 1988). A dummy variable is then used such that highly ranked firms are accorded the value of one, while all others are valued at zero. This paper evaluates prestige of law firms using both methods. First, the market share of all transactions in which the law firm provides legal counsel is divided by the total value of IPOs. Alternatively, we use the top ten firms appearing in the *AmLaw 100*, which designates top firms by the revenue. A dummy variable for firms in this top-ten list is created to address this method. To test the hypotheses in this manner, we assigned prestige to each law firm using the *AmLaw 100*,which ranks national law firms by revenue. This publication has been maintaining this list since 1987, which is prior to the time period of the present sample. While we concede that the measure of prestige for the law firms and IBs in this analysis has limitations, it provides a more granular identification of each firms level of prestige. It should be noted that all analyses that we conducted using both measures of prestige yielded similar results, with a higher level of measurable variance using the ratio method of calculating prestige.

We included additional controls in preliminary models, including the geographic region of the issuers. This control was initially considered since Canada has the highest number of first-issue IPOs (Hasan & Waisman, 2010) and therefore could potentially skew the results. We also investigated whether the number of shares retained by the IBs, the fees for services, the listing exchange, share type, and whether the investors were primarily retail or institutional. We also controlled for accountant firm prestige, since this has been the focus of study in literature investigating effects on IPO underpricing. In all cases, there was no statistically significant impact on prestige in the present analysis.

Conclusion

This present analysis investigates the effects of law firm prestige on the underpricing of IPOs. Specifically, to see whether there is any effect on the importance of the quality and the prestige of legal counsel for the issuer that is located in the United States, for international companies, or for a combined effort of US and whether international law firms has an effect on IPO underpricing. If the effects are prevalent, then what sort of impact is there: is it adverse or positive impact and why?

Our findings indicate that the prestige of manager law firms consistently reduce underpricing regardless of whether the law firms are only from one country or if firms from multiple countries are engaged to represent the investment banks. When the proceeds of the transactions are taken into consideration, the influence of high prestige manager law firms further reduces underpricing. Interestingly, we find that the inclusion of high prestige issuer law firms in an IPO transaction will increase underpricing if solely represented by foreign-based law firms. In other words, findings indicate that the prestige of law firms does matter with respect to IPO underpricing. Highly prestigious law firms that represent the manager investment banks will signal a higher level of quality of the IPO, and will therefore reduce underpricing. However, the issuer law firms that have higher prestige have the potential to actually increase underpricing due to increased levels of uncertainty. Accordingly, managers of firms will benefit from recognizing the level of prestige and the nationality of the firms when determining what firms should be engaged in the IPO process.

Management literature relating to reputational intermediaries suggests that organizational leaders should determine whether the incremental costs of engaging expensive and/or dominant consultative partnerships are necessary. Any decision made by management, so long as it is deemed to be rational and not based on managerial self-interest, will seek to maximize the benefits to the organization and its stakeholders. Maximizing the profit potential of listing on a stock market and acquiring capital are a critical goal of the IPO process. Engaging prestigious law firms may only serve to increase transaction costs in terms of actual resources expended on using these firms and the potential for unnecessary delays in completing the IPO due to increased layers of bureaucracy.

More notably, this study suggests that international companies listing on a stock exchange differing from that of their own country may be detrimental to the maximization of IPO proceeds if the prestige of the firm does not correspond with the nationality of the issuer or underwriting bank. Thus, it behooves managers of companies that are engaging in an IPO to take measures to signal the market value to avoid setting an offering price too low and suffer the opportunity cost of underpricing the stock.

This present study opensthe door to several opportunities for further research. The first finding indicates that the prestige of the issuer and manager law firms, as well as that of investment banks, were not correlated. Nevertheless, additional analysis would help in discerning whether investment banks influence the prestige attained by law firms that represent both the issuer companies and the managing underwriters. It is also plausible that law firms may have some influence on the prestige of other firms, as well as on that of investment banks. The second finding indicates that incorporating additional reputational intermediaries in the analysis, such as accountancy firms (Iyengar & Zampelli, 2008), may provide further insight into the influence of law firm prestige. A third finding indicates that the proceeds of IPO transactions could be tested as an independent variable along with an interactive effect rather than as a control variable.

Finally, and perhaps of greatest immediate interest for managerial considerations, more research is required to determine the reasoning and implications of the net overall curvilinear influence of issuer law firm prestige and investment bank prestige on underpricing. One could surmise that the market may perceive that more expensive and experienced firms were required to be engaged by the issuer company to manage potential concerns that would potentially cause the IPO to fail. This finding is of critical importance to companies undergoing the IPO process, in that incurring the costs to hire more prestigious law firms may ultimately result in lower IPO proceeds due to underpricing.

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